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# Intelligence Memorandum

*Canada's Changing Economic Relations With The United States*

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ER IM 71-115  
June 1971

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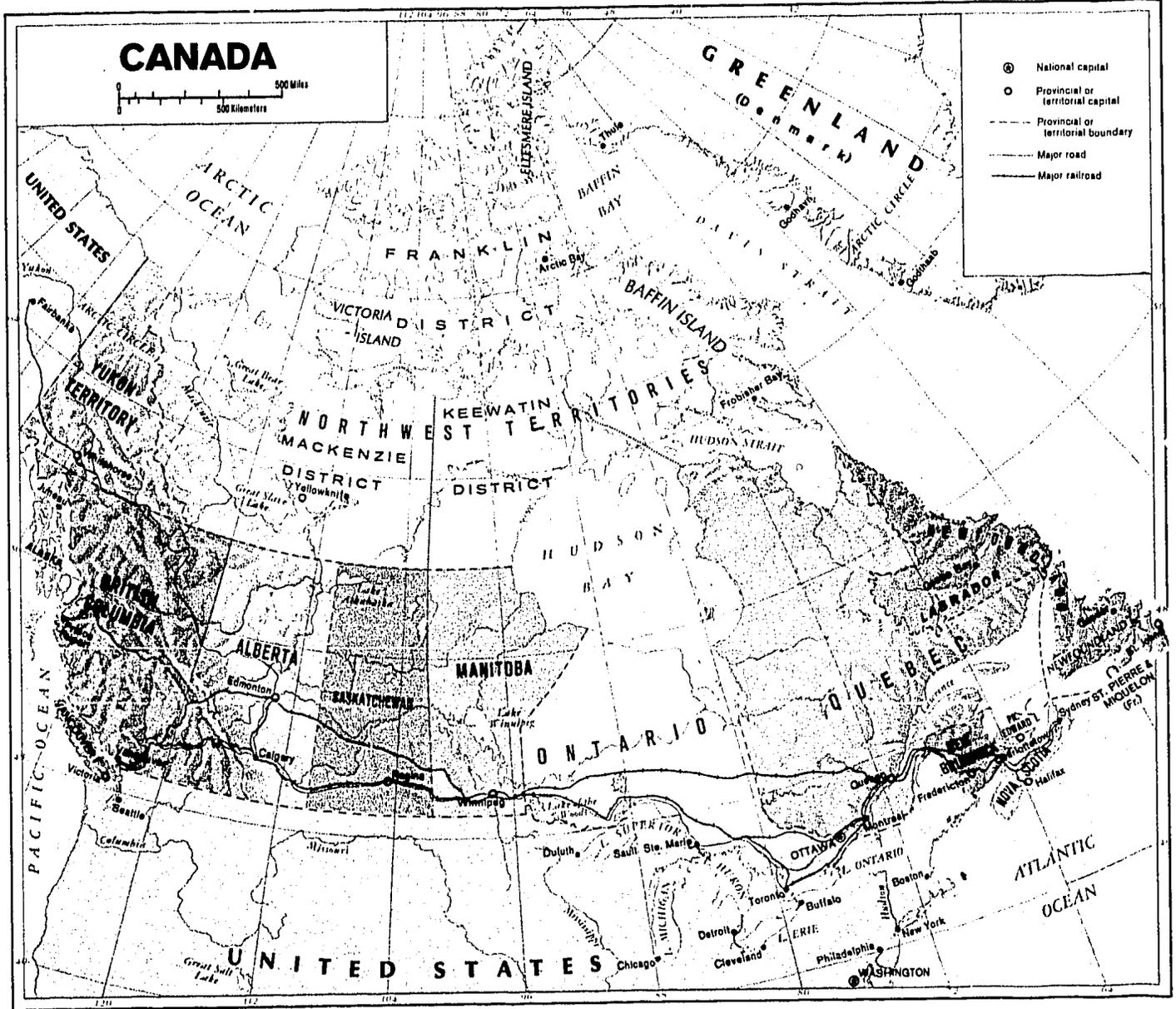


Figure 24. Canada: Economic Activity  
(Map) (Inside back cover)

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Figure 1



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CENTRAL INTELLIGENCE AGENCY  
Directorate of Intelligence  
June 1971

INTELLIGENCE MEMORANDUM

Canada's Changing Economic Relations  
With The United States

Introduction

1. Canada is the United States' most important trading partner. More than one-fourth of US trade is with Canada, and more than two-thirds of Canada's trade is with the United States. A US trade surplus with Canada, which was sustained for more than three-quarters of a century, shifted to a deficit in 1968-70. In 1970 this trade deficit -- almost \$1.4 billion -- was the largest the United States had with any country. Although much of the deficit is offset by the favorable balance on service transactions, the bilateral basic balance is in substantial deficit as well because of the large long-term capital outflow from the United States to Canada. The capital outflow into the mineral and forest products industries increases Canada's ability to satisfy US resource requirements, whereas the outflow into secondary industry increases Canada's competitiveness with the United States.

2. This memorandum and its eleven appendices examine in detail Canada's changing economic relations with the United States. It considers

*Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence. While not formally coordinated with other agencies, pertinent parts of the memorandum have been discussed with or reviewed by appropriate Officers in the Departments of Agriculture, Commerce, Interior, State, and Treasury.*

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Canada's mineral and energy developments, trends in agriculture and manufacturing -- particularly in the automotive sector -- and the role of US investment and finance in the Canadian economy. The memorandum also considers [redacted]

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[redacted] the role of Canada in the world economy.

### Discussion

#### Background

3. The most fundamental aspect of US-Canadian relations is the closeness and importance of the connections between the two countries. The continental United States and Canada share a 3,200-mile border (see the orientation map, Figure 1). Millions of Americans and Canadians and billions of dollars in merchandise trade -- \$20 billion in 1970 -- cross that border annually. For Canadians, the natural avenue for commerce runs to the United States, rather than across Canada. This is not surprising inasmuch as two-thirds of Canada's population of 21 million people live within 100 miles of the border. Although Canada is the world's second largest country -- after the Soviet Union -- only one of its 19 largest cities (Edmonton) is more than 200 miles from the United States.

4. Canada is the world's sixth largest trading nation and so is unusually dependent on the outside world, particularly the United States. Because of the relatively small population and limited domestic markets, abundant natural resources, and need for infrastructure capital, the Canadian economy is oriented toward international trade and foreign investment. Exports amount to 20% of gross national product (GNP) and about 60% of production of physical goods, a higher proportion than in any other major industrialized country (see Figure 2). Similarly, foreign investment plays a major role in the Canadian economy; foreign direct investment as a percentage of GNP is 12 times as important to Canada as to the United States. The flow of investment funds -- over \$4

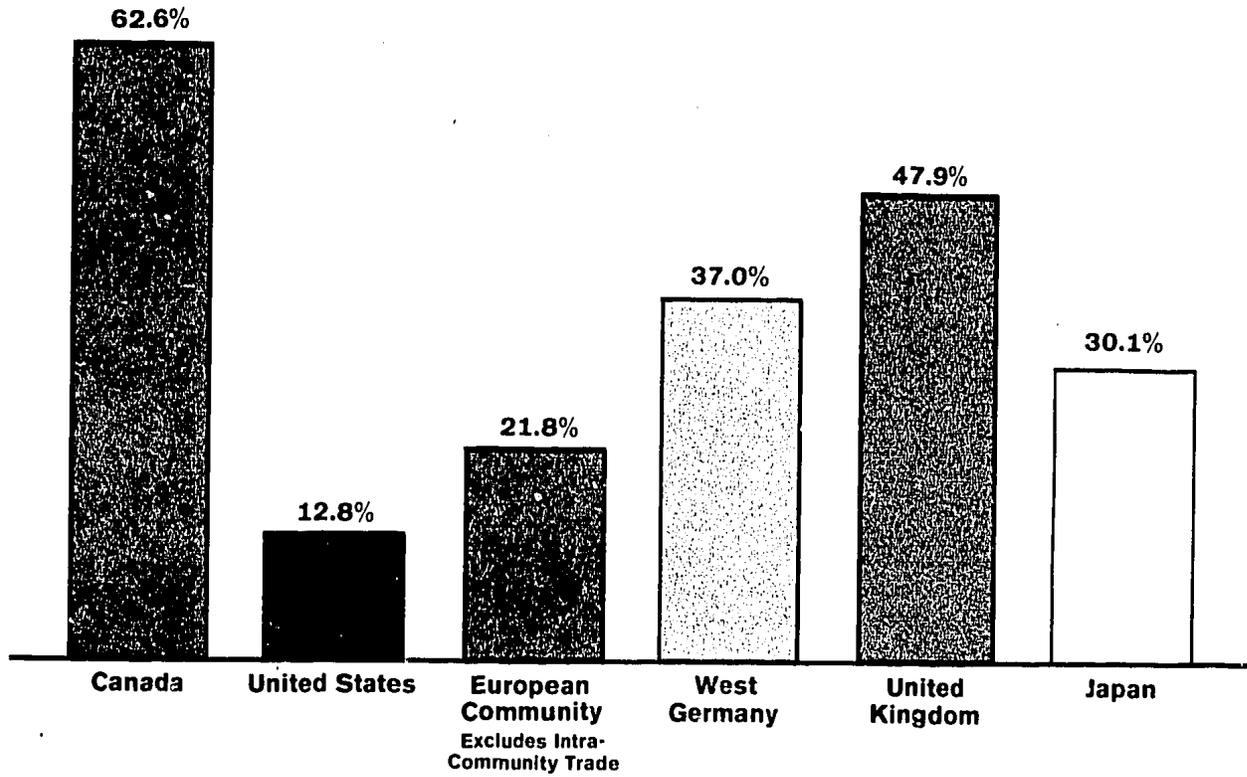
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### CANADA: An Open Economy

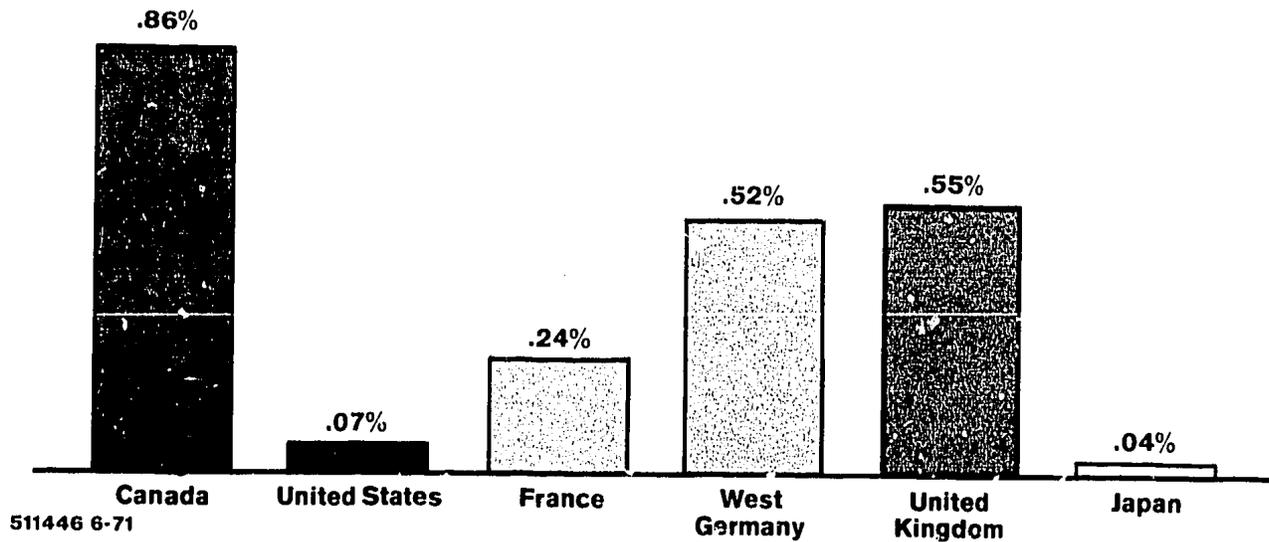
Figure 2

Exports in Relation to Production\*, 1969



\*Including agriculture, forestry, fishing, mining, quarrying, and manufacturing

Foreign Direct Investment as a Percent of GNP



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billion in 1970 -- and the volume of goods that crosses the US-Canadian border is many times greater than that between any other two countries.

5. The two countries are now each others' largest customer (see Appendix I, "Canada's Foreign Trade"). In 1970 the United States purchased 66% of Canada's exports and provided 71% of Canada's imports (see Figure 3). About one-fourth of US trade is with Canada, an amount substantially greater than our trade with the European Communities (\$15 billion in 1970) or with Japan (\$11 billion in 1970).

6. US-Canadian trade grew rapidly during 1966-70. While US trade with European members of the Organization of Economic Cooperation and Development grew 13.6% annually, US trade with Canada rose 14.3% annually; only US trade with Japan grew more rapidly -- 18.8% annually. The rapid growth in US-Canadian trade in the second half of the 1960s was due mostly to the automotive products agreement of 1965 and the ensuing 800% increase in exchanges of such goods since 1964 (see Appendix IV, "The US-Canadian Automotive Products Agreement").

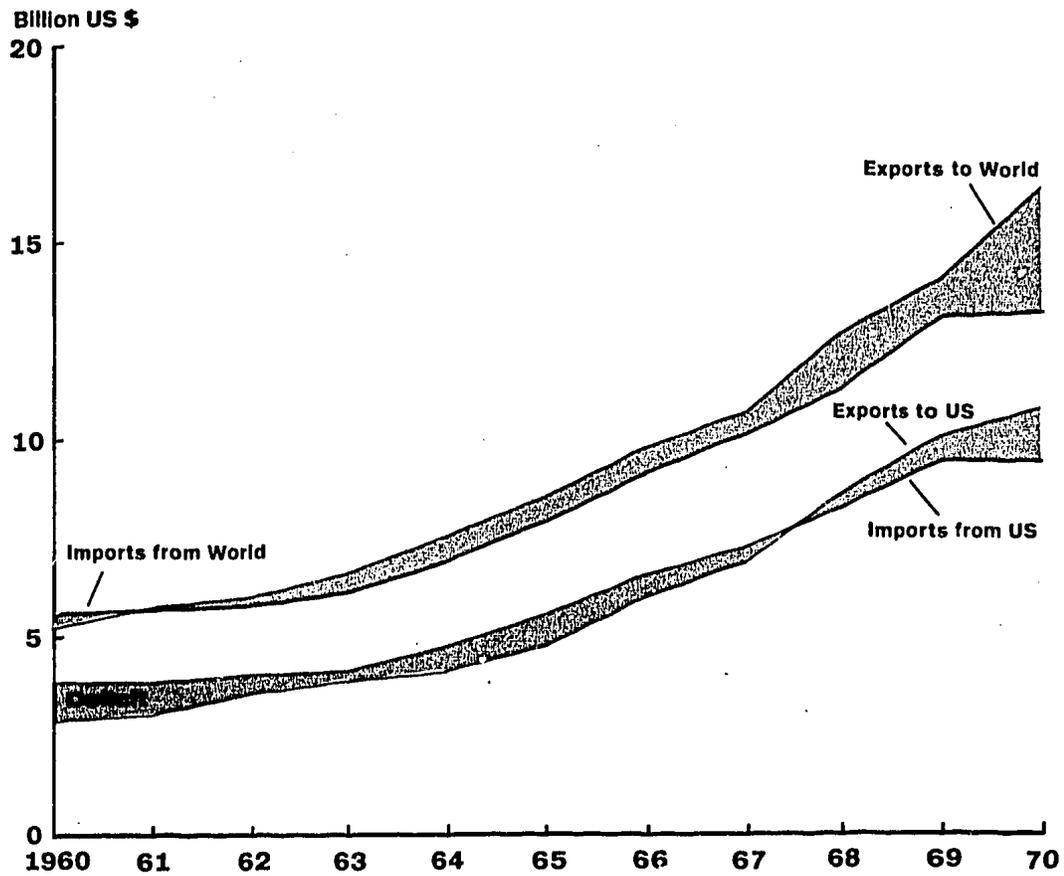
7. The most significant change in US-Canadian trade has been the shift in the trade balance. Canada traditionally showed a heavy deficit in its trade with the United States, which was offset by a surplus in trade with other countries, by foreign investment, and by borrowing in the US capital market. The trade deficit averaged about \$600 million annually in the 1950s and early 1960s. In 1968, however, for the first time since 1891, the United States had a trade deficit with Canada. In 1970 the US deficit with Canada, which we estimate to be nearly \$1.4 billion, was the largest with any of our trading partners.\*

*\* Although there are other estimates of the size of the deficit -- the official Canadian figure is \$1.1 billion, the adjusted US balance-of-payments estimate is \$1.6 billion, and the unadjusted US bilateral trade figure is \$2.0 billion -- we believe the \$1.4 billion figure is the most accurate balance-of-payments measure of the bilateral trade deficit. See also Appendix XI, "Methodology."*

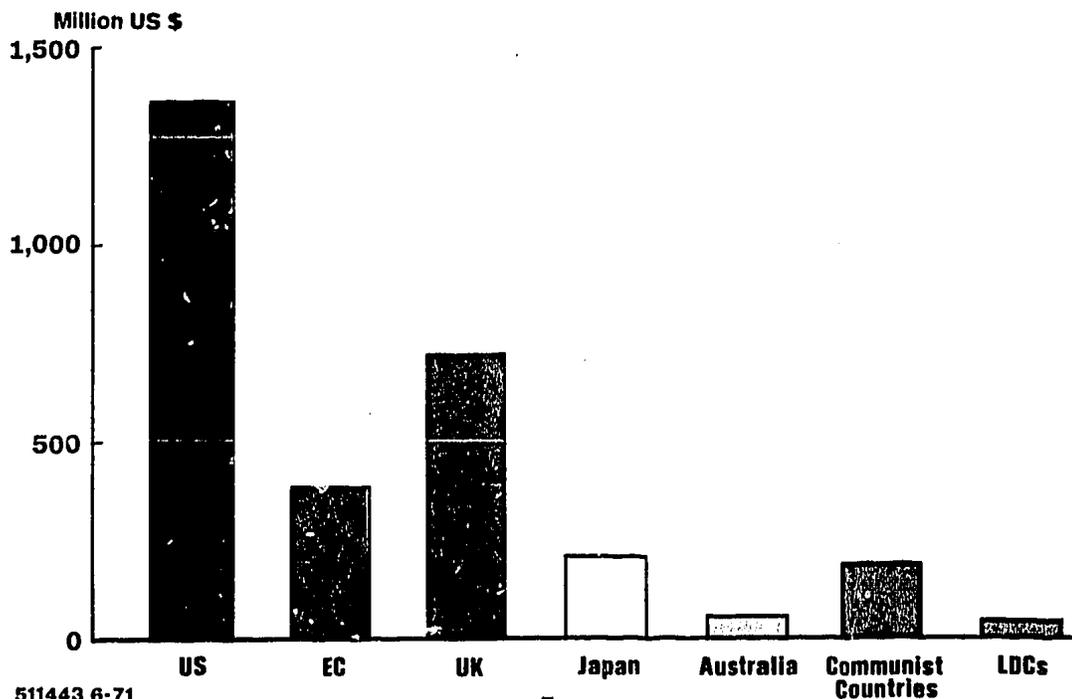
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**CANADA: Trade with the US and the World**

**Figure 3**



**Bilateral Trade Surpluses, 1970**



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8. The US and Canadian economies are closely linked by corporate and financial ties as well as by trade ties. In the post-war era when US companies have invested heavily throughout the world, Canada has received the lion's share of new investment (see Appendix VI, "US Investment in Canada"). In 1970, about 20% of US overseas direct investment was made in Canada; all told, 30% of US foreign direct investment is now located there. US investments represent 80% of all non-resident investment in Canada; US citizens control about 45% of the assets in Canadian manufacturing, 50% in the oil and gas industries, and 51% in mining and smelting.

9. New York is as much the capital market for Canada as for the United States (see Appendix VII, "Canadian Financial Markets"). The value of Canadian bond issues offered in the US market totaled about \$800 million annually in 1968-70. Canadian government entities and banks have often temporarily invested their surplus US dollars in New York, although in recent years the Eurodollar market has become more attractive for short-term placements. Because of the inter-dependence of the countries' financial markets, small differences in interest rates can lead to massive flows of funds across the border if both currencies are pegged at a fixed parity.

10. US and Canadian GNPs tend to move together because of the countries' close economic ties (see Figure 4). Changes in the US economy are mirrored in Canada -- generally in an exaggerated form -- although since 1962 the Canadian economy has consistently grown more rapidly in real terms than has our own. To help insulate Canada from economic developments, Ottawa unpegged its exchange rate in May 1970 and permitted the Canadian dollar to float (see Appendix VIII "Canada's Floating Dollar"). Even with a floating rate, Ottawa's capability for embarking on an independent course of economic action is quite limited, because links between the two economies are so strong.

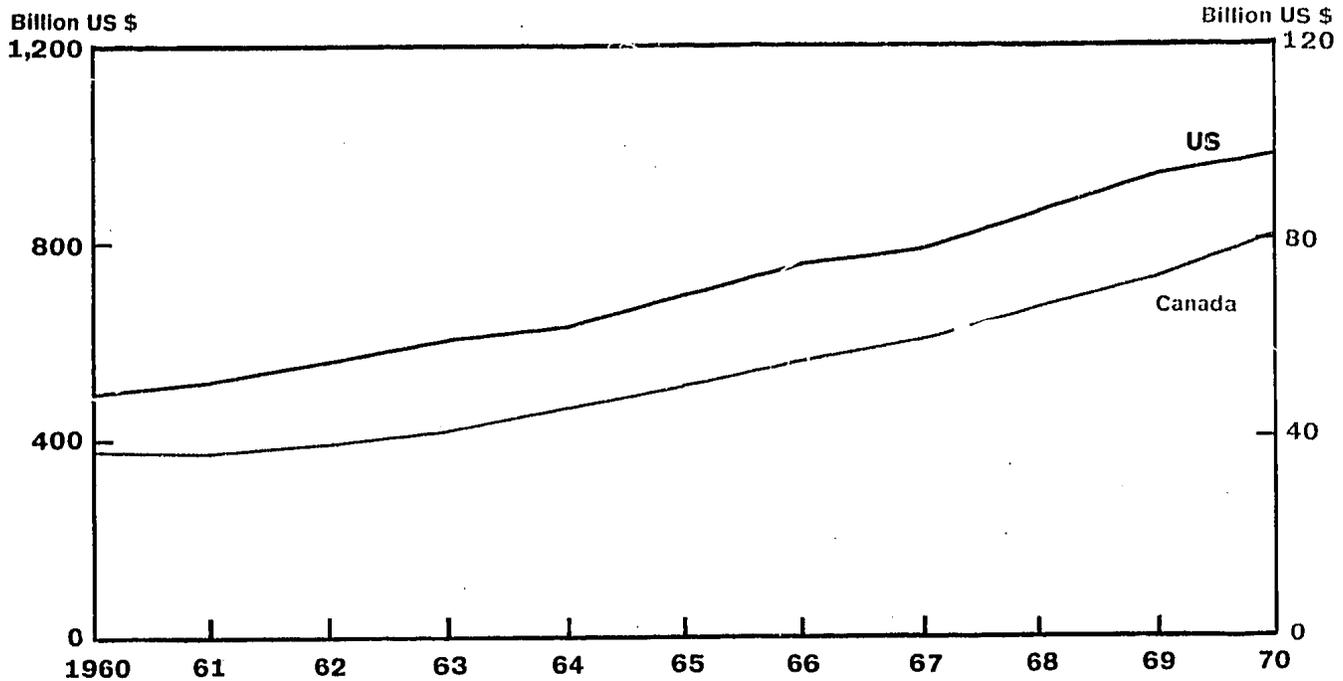
11. Canada's proximity to, and economic dependence upon, the United States is a constant irritant to Canadians, although most Canadians

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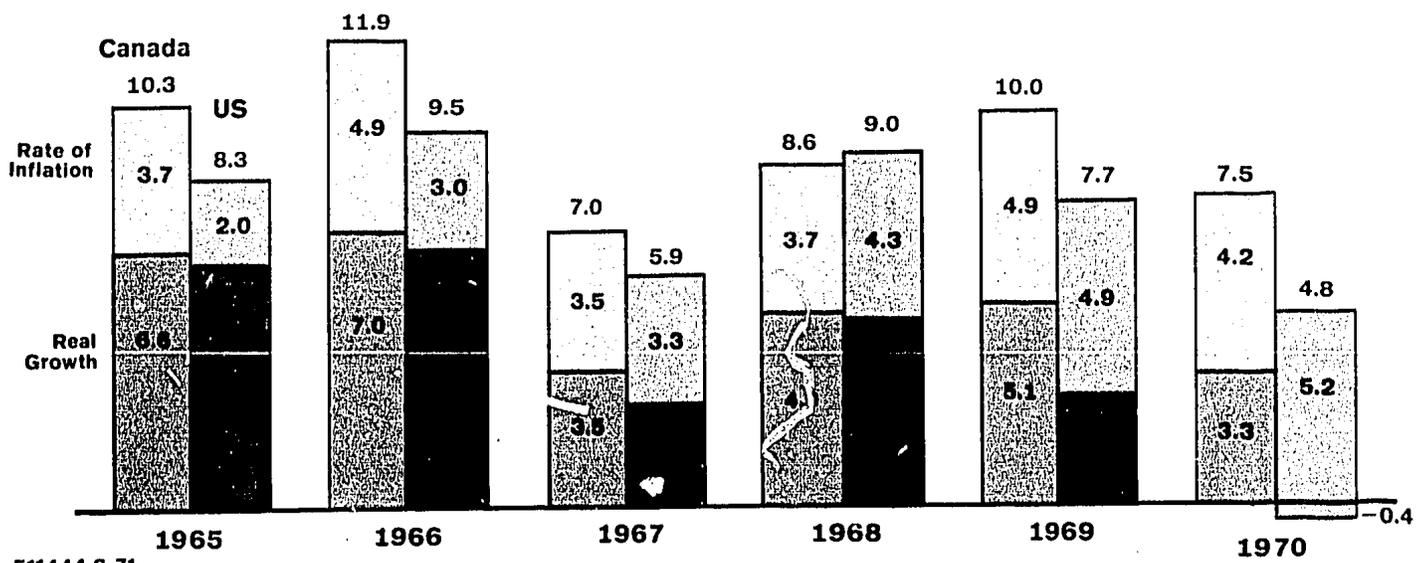
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**CANADA and US: GNP Growth**  
Canada and US GNP

Figure 4



**Percent Growth**



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accept this dependence as a necessary adjunct for economic development

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Canadian economic nationalism, partly reflecting difficulties in developing a unique identity, is not new. Much of Canada's political history has involved gaining independence from Britain while resisting absorption by the United States. Nevertheless, economic nationalism has become an increasingly attractive political issue.

### Evolving Trade Relationship

12. The character of US-Canadian trade relations has changed in the last few years as Canada has come of age. Partly because of Ottawa's efforts to diversify, the Canadian economy has become more competitive with the US economy, and the composition and balance of US-Canadian trade has shifted. Growth in Canadian import demand has been retarded by the relatively slow growth of the economy, while US demand for Canada's traditional exports has remained strong, thereby eroding the US trade surplus.

### Composition of Trade

13. Canada's abundant natural resources are the foundation of the economy and account for Canada's importance in world trade. Traditionally, Canada exported staples -- wheat, crude oil, processed minerals, and newsprint -- both to the United States and elsewhere, while importing technologically advanced manufactures, primarily from the United States.

14. Historically, the US and Canadian economies have been largely complementary rather than competitive, with Canada supplying the resources the United States required and the latter supplying the investment funds Canada needed to develop its resources and the manufactures it could not produce itself. Canada has been moving away, however, from being primarily a resource-based exporter. Exports of staples, although increasing in absolute terms, have declined to about 40% of total exports. Intermediate and final products now predominate. Almost 90% of imports still fall

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into the same category, but half of these goods undergo further processing in Canada (see Figure 5).

15. The shift in Canadian trade composition is attributable to various factors, the foremost of which is Ottawa's desire to develop manufacturing in order to increase job opportunities, raise real wages, and reduce dependence on imports. Canada has the most rapidly growing labor force of any industrially advanced Western country. Large numbers of new workers probably cannot be employed in mineral, fuel, and forest product industries, which tend to be capital- and resource-intensive, not labor-intensive. Thus, only a rapid expansion in manufacturing, along with the continued growth of the service sector, promises to meet Canada's long-term employment needs.

#### Development of Manufacturing

16. Canada is often unable to take advantage of the economies of scale so important in manufacturing (see Appendix V, "Manufacturing and Agriculture in Canada"). Canadian per capita GNP is about 80% as high as US per capita GNP, but total Canadian income, because of Canada's smaller population, is only 8% as large (see Figure 6). Typically, Canadian firms are subsidiaries of large US corporations and produce their entire product range in Canada. The degree of product differentiation thus is unusually great for that size of economy and the problem of inefficient scale is aggravated.

17. Except in export-oriented resource industries, Canadian manufacturing has developed in a protected market and is often unable to compete in the international arena without government assistance. The average level of Canadian tariffs is relatively high for an advanced industrialized country (see Figure 7), and a significant number of very high tariffs are maintained to protect inefficient manufacturing industries.

18. To ease the handicap of short and inefficient production runs, Ottawa is seeking to "rationalize" its industries. Instead of producing a wide variety of goods for the relatively

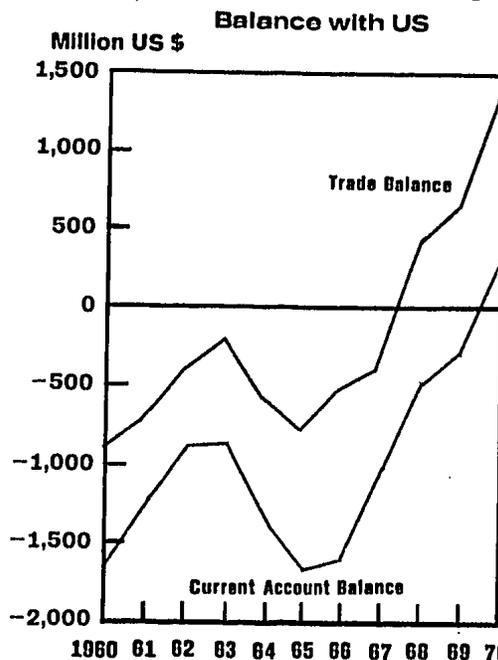
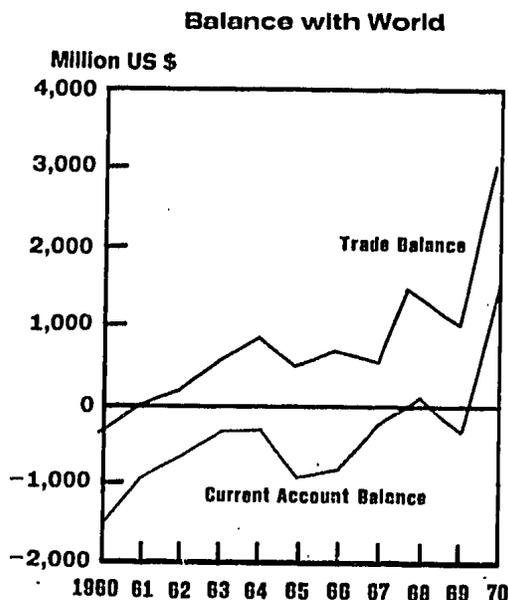
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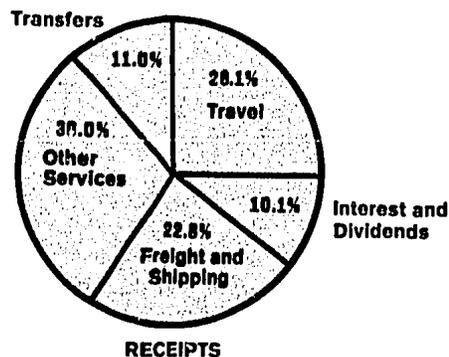
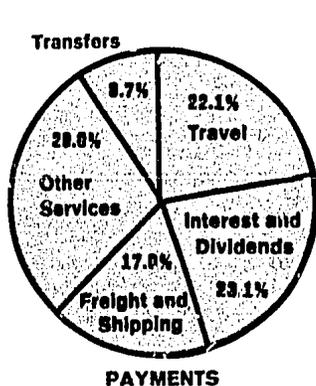
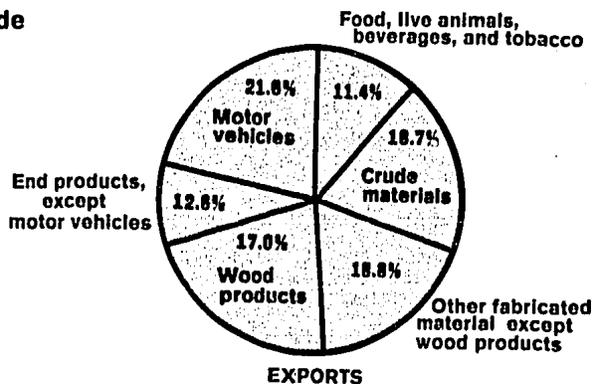
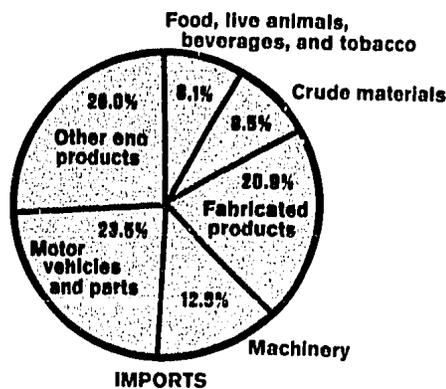
**CANADA: Current Account**

Trends

Figure 5



**World-wide Composition, 1970**

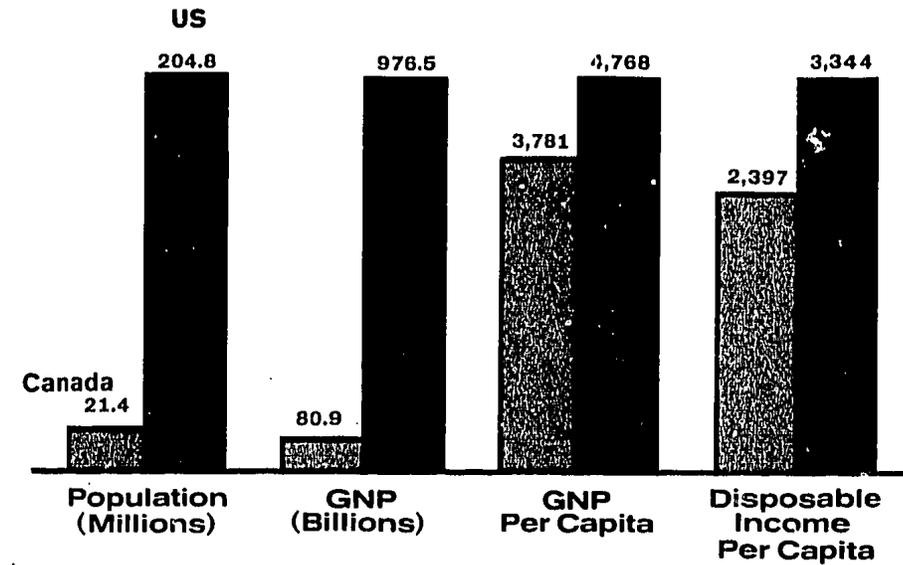


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**Figure 6**

**CANADA and US: Population and Income\*, 1970**



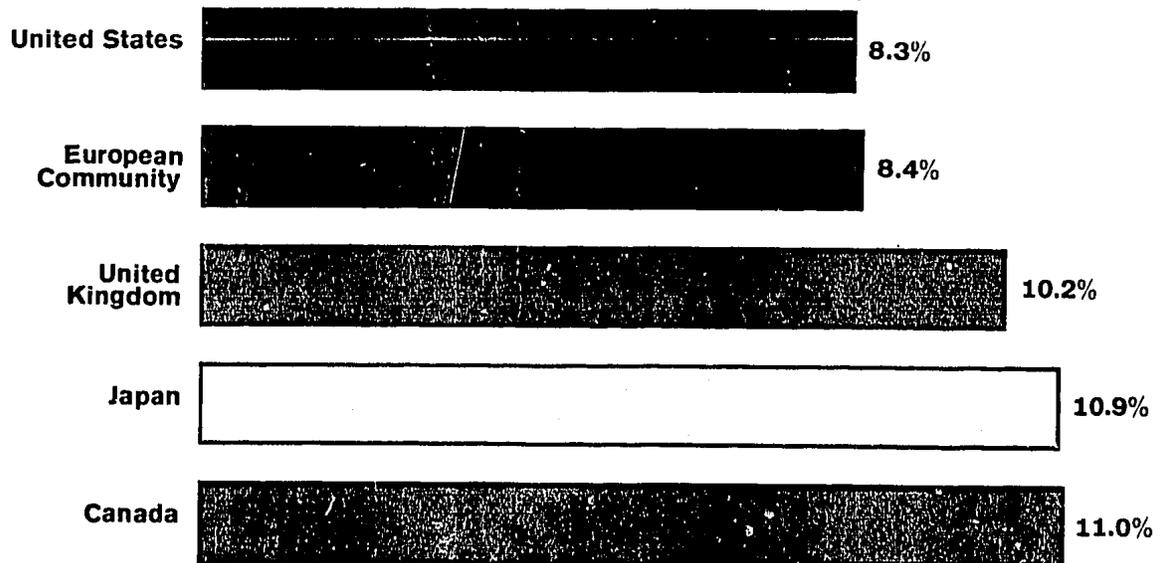
\* In US dollars

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**CANADA: Comparative Tariffs**

**Figure 7**

**Average Tariff Rates after Kennedy Round Implemented**



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small domestic market, the government is striving to have industries specialize in certain product lines for both the domestic market and export -- primarily to the United States. An export promotion effort has consequently been undertaken for manufactured goods. Ottawa has also favored additional free trade agreements with the United States similar to the 1965 automotive products agreement.

19. The automotive products agreement established duty-free trade between Canada and the United States in this sphere, subject to certain production guarantees given to Canada that the US Government believed would be transitional. Under the agreement, bilateral trade in automotive products increased from less than \$705 million in 1964 to more than \$6 billion in 1970. Because Canada's exports increased more rapidly than US exports, our trade balance for automotive products shifted from a surplus of \$560 million in 1964 to a deficit of \$315 million in 1970. The \$875 million swing in this trade balance explains 45% of the deterioration in the overall bilateral trade account in this six-year period.

20. As Canada becomes more aggressive in export promotion, conflicts sometimes arise with US interests and regulations. Canada's efforts to rationalize its auto industry through an extended-content and duty-rebate program in 1964 probably would have led to countervailing US duties, and possibly a trade war, had the automotive products agreement not been negotiated. Similarly, the special import duty exemption and construction incentives being offered the two new Michelin Tire Company plants in Nova Scotia -- 85% of whose radial tire output is slated for export to the United States -- seemingly conflict with a tariff concession previously negotiated with the United States and could lead to a countervailing US duty and an escalating series of retaliatory trade measures. The pressure put on US subsidiaries in Canada to increase their assembly operations and buy more of their inputs in Canada as a *quid pro quo* for their Canadian sales, although less dramatic and less likely to lead to a trade conflict, is still inimical to US domestic interests.

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21. Canadian exports of manufactures have been helped substantially by government export policies as well as by the rapidly growing US market for finished manufactures from all sources. Automotive exports, stimulated first by the duty rebate program and then by the automotive products agreement, grew from less than 2% of Canada's exports to the United States in 1964 to 30% in 1970. Exports of defense equipment to the United States, helped by the Defense Production Sharing Arrangement and special Canadian grants to assist defense production, have totaled about \$2.4 billion since 1959. Although the Canadians have agreed to assure the maintenance of a long-term balance in bilateral defense purchases, US sales in the period were only about \$1.9 billion.

Traditional Exports and the Current Account  
Balance

22. Canadian mineral exports to the United States have also increased greatly (see Appendix III, "Canadian Metals and Minerals"). In the past decade, Canada's total mineral exports grew at an average annual rate of 13%, about three times as fast as GNP. An increasing proportion of mineral exports other than fuels has gone to Japan and the European Communities, although US dependence on Canadian imports has also increased.

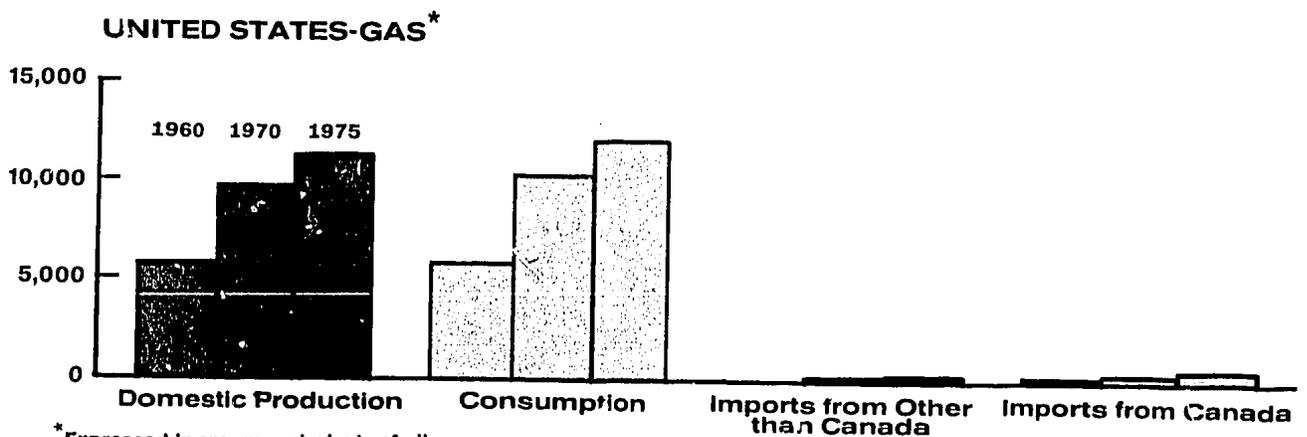
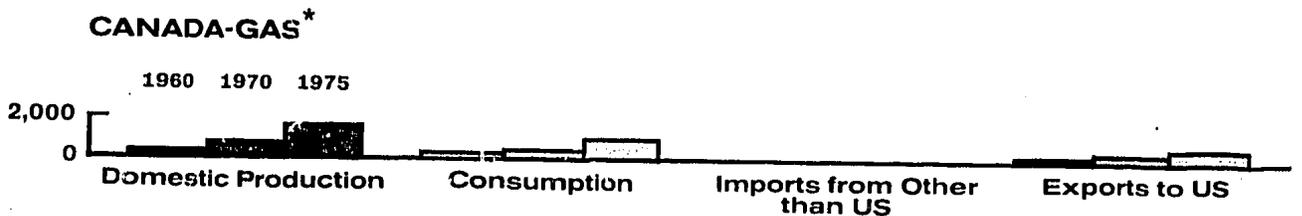
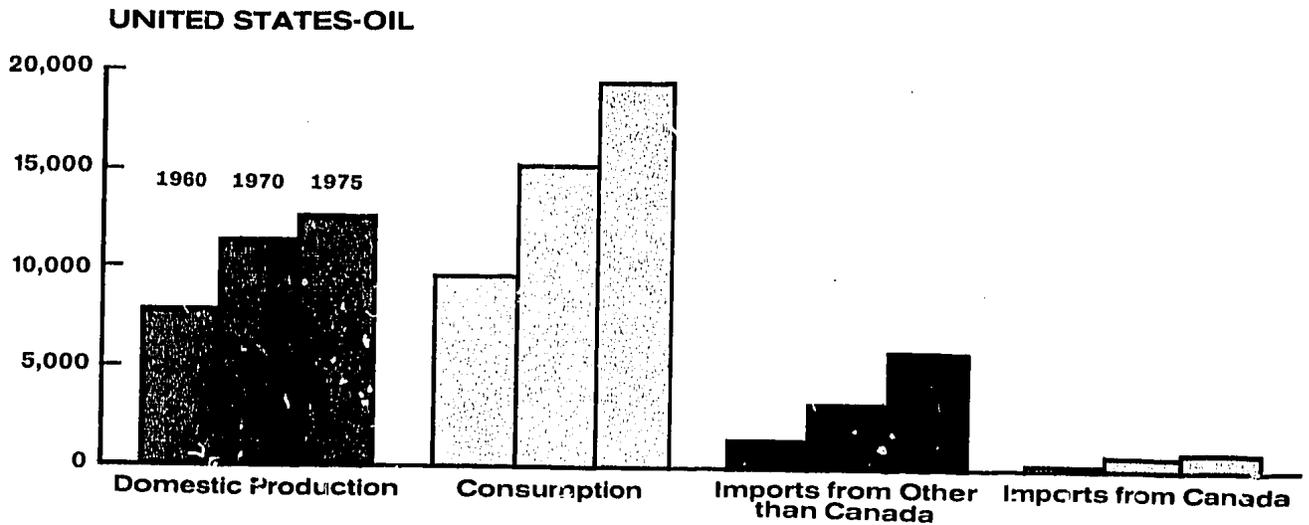
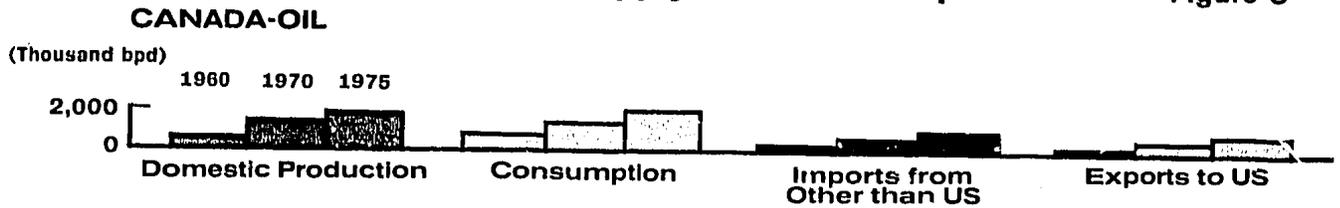
23. Canadian crude oil and natural gas exports to the United States grew 21% annually during the 1960s (see Appendix II, "Canadian Energy Base"). In the early post-war years the United States was Canada's principal supplier of petroleum, but by the mid-1950s Canada had become a net exporter to the United States. Spurred by the exemption from mandatory oil import quotas until March 1970, Canadian crude oil exports grew to about 25% of total US imports (see Figure 8). In 1970, Canada was our largest single foreign supplier of crude oil and of natural gas with combined sales totaling \$819 million.

24. Since 1965, Canada's total exports have grown at an average annual rate of 14.1%, while imports have grown at an average annual rate of

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## CANADA and US: Energy Supply and Consumption

Figure 8



\* Expressed in energy equivalents of oil

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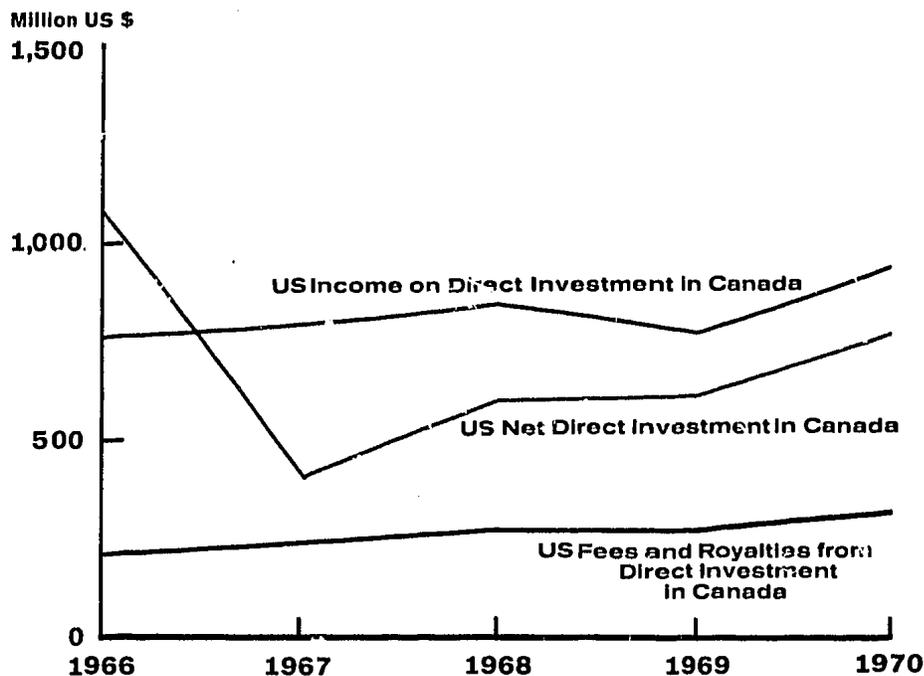
10.8%. In 1970, exports grew 17% while imports grew only 2%. The slow growth in imports last year is attributable, in part, to Canada's economic recession; the real growth of output reached only 3.3% in 1970. Ottawa's efforts to diversify the economy and increase job opportunities by developing the manufacturing sector and increasing manufactured exports come at a time when demand for Canada's traditional exports is very strong, while growth in Canadian import demand is lackluster. The consequence, then, has been to shift the balance of trade in Canada's favor, at the expense of many of its trading partners -- particularly the United States.

25. The deterioration in the US current account with Canada has not been as quick or as sharp as the deterioration in the trade account. The bilateral current account remained in surplus until 1969; in 1970 the deficit was only \$311 million compared with the \$1.4 billion trade deficit. Dividends on US direct investment in Canada increased from \$766 million in 1966 to \$939 million in 1970 (see Figure 9). During the same period, fees and royalties associated with direct investments increased from \$215 million to \$304 million, interest payments and income on portfolio investment increased from \$515 million to \$836 million, and other service receipts -- including gross receipts for transportation and travel -- grew from \$904 million to \$1,280 million.

Corporate and Financial Ties

26. No feature of US-Canadian economic relations is so conspicuous to the Canadians or so charged with emotion as US direct investment. US investment has assumed a pervasive influence in the economy resulting in ambivalent Canadian attitudes as to its desirability and effects. Some Canadians identify US subsidiaries in Canada with some national monolith, "the United States." Fears of loss of economic sovereignty, especially to US-based multinational corporations, and dislike of extraterritorial extensions (mostly potential) of US laws and regulations -- for example, trading with the enemy and anti-trust

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**CONFIDENTIAL****CANADA and US: Investment Flows****Figure 9**

acts -- have led to the consideration of measures to assure that foreign-controlled firms are responsive to Canadian national policies. Ottawa is awaiting a report being prepared by Minister of National Revenue Herbert Gray that will recommend whether or not the government should apply more stringent controls on foreign investment. Until it has time to consider the recommendations in this report, Ottawa is reluctant to discuss the topic.

27. The export performance of US subsidiaries in Canada is substantially better than that of Canadian-owned firms, and US subsidiaries have been more successful in displacing US imports. These accomplishments reflect the fact that US-owned firms have been more successful, under Canadian Government pressure and with Canadian

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US industrial tariffs generally are low, and the firms frequently have established reputations, extensive distribution systems, and a wide range of manufacturing facilities in the adjacent US market. Given these conditions, at little cost to themselves, they produce part of their product line in Canada -- for consumption both in Canada and the United States.

28. Canadian subsidiaries of US firms appear willing to adjust the distribution of their production in response to Canadian pressure, where it is not particularly costly to do so. In the absence of countervailing US Government pressure, the companies have found it easy to accommodate Canada. Canada, for example, has succeeded in pressuring US computer-manufacturing companies to increase their research expenditures and "source" more of their production in Canada, and has induced US automotive manufacturers to increase their investment and share of production there.

29. US investment in Canada is exempt from the Foreign Direct Investment Regulations established in 1968 to limit overseas direct investment by US companies, and from the Interest Equalization Tax (IET) on investment in new securities. Both exemptions were requested by Ottawa to protect Canada's balance-of-payments position. Canada agreed, in return, to establish guidelines and a reporting system to make it more difficult for institutions to evade the regulations by using Canada as a "pass through" to other countries. Earlier, in 1963, the Canadians had agreed to a ceiling on official Canadian reserves.

30. The outflow of US funds to Canada has persisted and grown, in part because of the exemptions. In 1970 the net long-term capital outflow totaled about \$835 million (see Figure 10), and the outflow probably amounted to \$300-\$400 million in the first quarter of 1971. Continued long-term borrowing in the United States by Canadian citizens and the provincial governments, at a time when Canada's current account is in substantial surplus, almost certainly disregards our understanding with Ottawa -- accepted as a *quid pro quo* for the removal of the reserve ceiling in 1968 -- that it would limit borrowing in the United States.

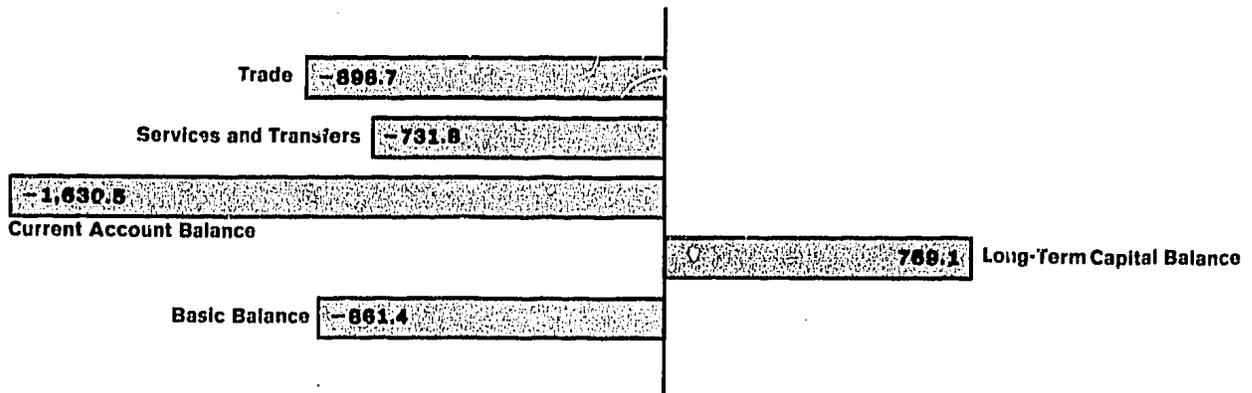
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**CANADA: Balance of Payments with the US**

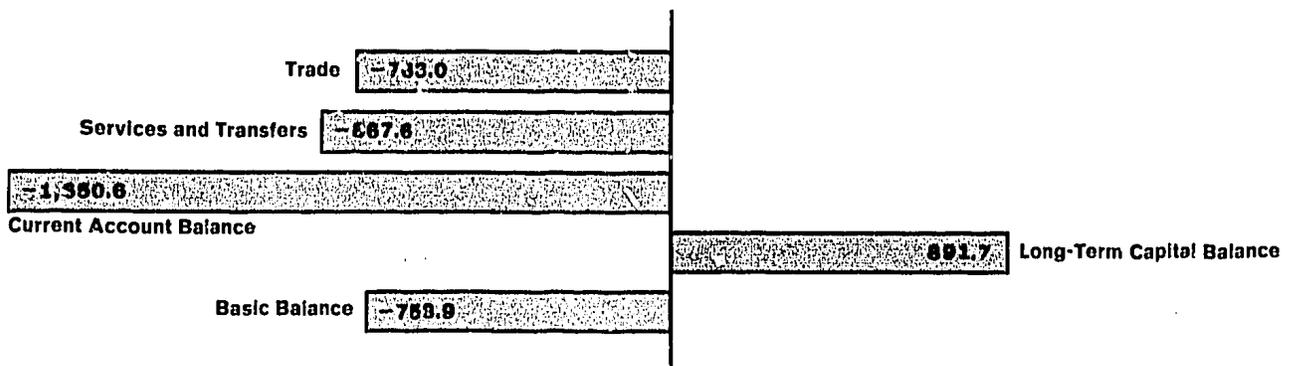
**Figure 10**

Million US \$

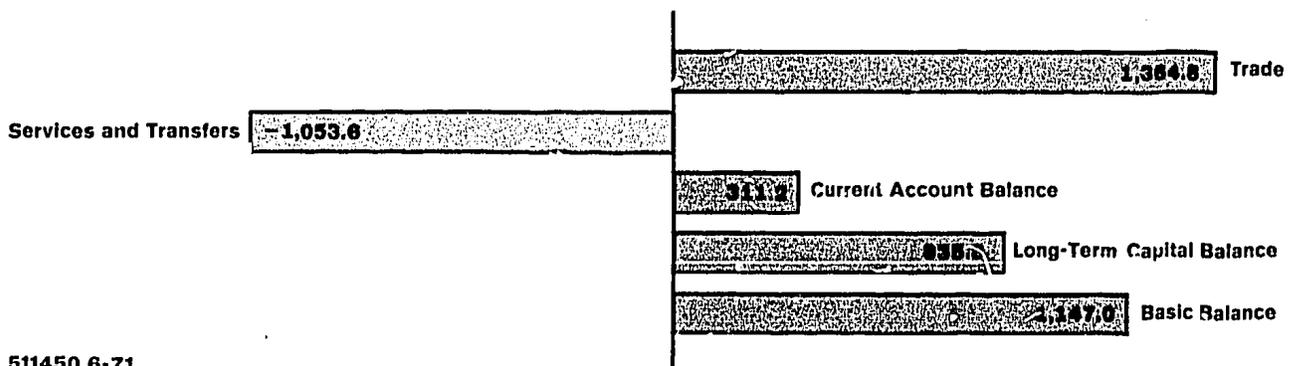
1960



1965



1970



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31. The effect of Canada's disregard of the understanding is to increase Canadian reserves and to worsen substantially the US basic balance -- that is, the balance on current account plus long-term capital, often considered to be the best measure of US international economic performance. We estimate that the deficit in our bilateral basic balance with Canada in 1970 was \$1,150 million\* -- slightly more than half our worldwide basic balance deficit (see Figure 11). Only the US basic balance deficit with Japan was larger -- \$1,740 million. Canadian reserves in May 1971 reached almost \$5 billion, compared with the \$2.55 billion ceiling set in 1963 and dropped in 1968. Most of Canada's foreign exchange reserves are invested on a short-term basis in New York.

32. To finance the growth in reserves and keep the Canadian dollar within three-fourths of 1% of its pegged rate, Ottawa had to enter the foreign exchange market repeatedly and sell Canadian dollars. Unwilling to risk the inflationary consequences of a growing money supply, the government decided in May 1970 to float its dollar. A completely free float would theoretically change the exchange rate, move Canada's overall international payments toward balance, and keep its level of reserves relatively constant. However, in 1970 the overall payments surplus was \$1.5 billion, suggesting that the float may have been administered.

33. The free Canadian dollar showed unexpected strength gradually appreciating to near parity with the US dollar. Accordingly, Canadian exporters and manufacturers of import substitutes have been forced to cut their prices and profits or see their market position eroded. To avoid damaging Canada's competitive position in the world economy, the government probably intervened to prevent any further substantial appreciation in the Canadian dollar. It is believed that the Canadians ultimately seek to repeg their dollar at a level of about US \$0.96.

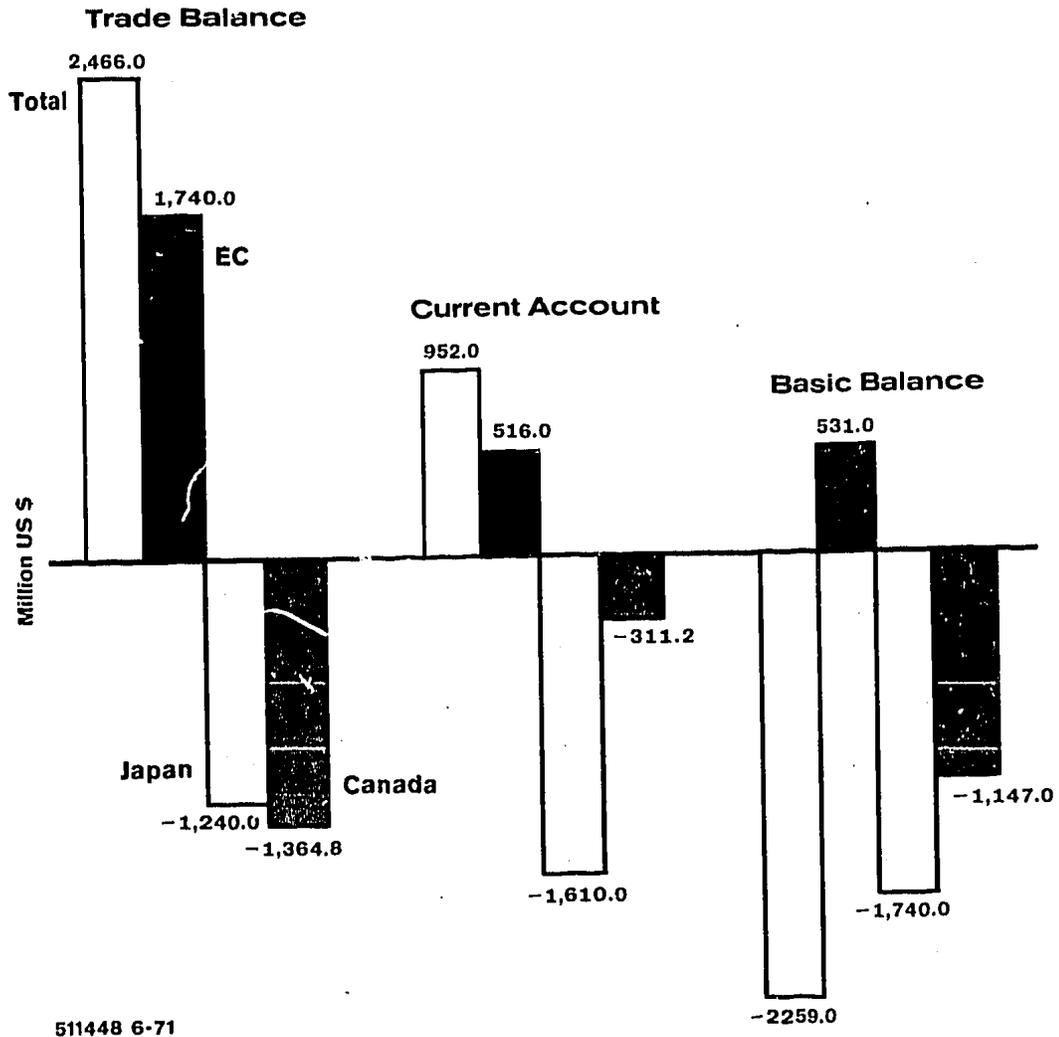
\* See Appendix XI, "Methodology."

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Figure 11

### US Trade, Current Account and Basic Balances, Worldwide and with EC, Japan, and Canada, 1970



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**CONFIDENTIAL**Issues in US-Canadian Economic Relations

34. Both the United States and Canada benefit greatly from their bilateral economic relations. The United States has access to a stable and secure source of forest products and minerals, including fuels. US companies earn income on their large investments and on their growing exports. The economic gains are proportionately even greater for Canada. The Canadians with the help of US capital and with access to the US market are able to exploit their resources profitably and expand manufacturing. US-Canadian economic relations are not free from problems, however. The number of these has increased in recent years as Canada has come of age and has asserted itself and as we have become more concerned with our balance-of-payments performance.

35. The United States is particularly concerned about the manner in which the automotive products agreement has operated (see Appendix IV). Because of the loss in potential US automotive production as a result of the agreement and sharp deterioration in the automotive trade balance, our government has asked Ottawa to drop the transitional production guarantees given Canada in the agreement. Although they agreed in July 1970 to at least a partial suspension of the transitional arrangements, the Canadians are now unwilling to suspend the arrangements without adequate offsetting compensation.

36. We believe that the continuing deterioration in the automotive trade balance is no longer due to the transitional arrangements. Clearly, these arrangements had an impact in the early years, when the auto makers increased their Canadian investments to satisfy the production guarantees. The vehicle manufacturers overestimated the growth of the Canadian market and "over-invested" in new facilities, however, so they have continuously exceeded the agreements requirements. It is extremely unlikely, therefore, that the elimination of the arrangements alone would promptly and significantly benefit the United States. Thus, no compensatory arrangement seems to be warranted.

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37. The root cause of the continuing automotive trade deficit is that, at the margin, US automotive executives with subsidiaries in Canada appear willing to give in to Canadian Government pressure regarding the distribution of production when it is not particularly costly for them to do so. Because Canadian production costs have probably now been reduced to the US level, the companies have been willing to accommodate Canada. Moreover, the producers are unwilling to let their new productive capacity in Canada go unutilized and are under some obligation to purchase parts from their traditional suppliers, who invested in Canada at their suggestion.

38. Other bilateral trade frictions also stem from Canadian efforts to diversify the economy and develop manufacturing through increased exports. Canadian export promotion techniques, including the practice of exerting pressure on US subsidiaries to use more Canadian products and facilities, often conflict with US interests and regulations. These efforts have led to trade conflicts in the context of the Defense Production Sharing Arrangement and could lead to a major trade confrontation in regard to the new Michelin Tire Company project in Nova Scotia (see Appendix V).

39. Establishment of the two new Michelin plants is a politically sensitive issue in Canada. The duty exemptions and incentives being given the plants conflict with US interests. The US position is that the tariff concessions violate US tariff rights under the General Agreement on Tariffs and Trade (GATT). The construction incentives could also make Michelin tires produced in Canada subject to a US countervailing duty on the basis that they are a subsidized export. Because of the advanced stage of the project and its political significance to the Canadians -- it is one of Prime Minister Trudeau's pet projects -- the options available to the United States are unattractive. Withdrawal of equivalent tariff concessions or countervailing duty action would have adverse political repercussions and could lead to an escalating series of retaliatory trade measures.

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40. Canadian efforts to increase manufactured exports come at a time when our Canadian trade balance already shows a large deficit. US imports of Canadian minerals, including fuels, have steadily risen, though uranium imports have declined because of the US embargo on Canadian uranium for end use in the United States, which was imposed over Canadian objections (see Appendix III). Because of the embargo, Canadian uranium output has declined from a peak of \$342 million in 1959 to only \$48 million in 1970.

41. Canadian crude oil receives special treatment in the very profitable US market owing to the security of overland imports. Canadian oil and natural gas exports to the United States grew 21% annually during the 1960s (see Appendix II). Canada nevertheless is a net oil importer, relying on less expensive oil obtained primarily from the Caribbean and South America. If deliveries of overseas oil to Canada were interrupted, some Canadian exports to the United States would be subject to diversion to satisfy Canadian domestic demand. The United States accordingly is unwilling to remove present restrictions on oil imports from Canada without some assurances, possibly as part of a common energy policy, that a like amount of oil would be available to meet emergency needs. The Canadians oppose such a policy because they fear any agreement with the United States on energy exchange could result in too close a relationship with us.

42. In the areas of finance and investment, US-Canadian bilateral economic problems center on continued Canadian recourse to US capital and growing Canadian nationalism. Ottawa has obtained exemptions from all the regulations affecting US overseas lending and investment except for the Interest Equalization Tax on the resale of already issued securities (secondary marketing), and Canada continues to borrow substantial sums in the New York capital market (see Appendix VII). The Canadians are fearful at the same time of a further undermining of their economic sovereignty [redacted]

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[redacted] For its part, the United States is concerned that any measures Canada may adopt on

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the basis of the Gray and subsequent reports will involve *de facto* discrimination against US investment.

43. In addition to the broad problems concerning trade and finance, US-Canadian economic relations are beset by several minor irritations. The United States is concerned, for example, about Canada's unilateral extension of its territorial seas to 12 miles and its extension of pollution controls 100 miles into the Arctic Ocean; the increase in Canadian meat exports -- made possible by large meat imports from Oceania -- which has undercut the "voluntary" meat export quota program (see Appendix I); and Canada's failure to agree to four international customs conventions facilitating temporary admission of professional equipment and commercial samples. The Canadians, in turn, are concerned about our failure to increase the number of transborder air routes after several rounds of negotiations; immigration restrictions that make it more difficult for Canadians to come to the United States to work for a few years; and the manufacturing clause of the US copyright law that denies copyright protection to works by US citizens not published in the United States. Both the United States and Canada are concerned with several joint problems such as pollution in the Great Lakes -- although some progress has recently been made in this area -- and the charges and operating procedures established for the St. Lawrence Seaway.

**Prospects and Conclusions**

44. US-Canadian economic relations are likely to remain very close in the foreseeable future, despite new friction points which will surely develop from time to time. The problems that beset our bilateral relations are unlikely to lead to a major confrontation. Although Canada would like to reduce its dependence on the United States, it cannot find large and dependable alternative markets for its minerals, forest products, and manufactures. Similarly, Canada would be unable

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to find alternative sources of investment capital and would have difficulty in obtaining the sophisticated manufactures it buys in the United States. Although Canada's trade with its Pacific basin partners and with an expanded European Community (EC) is likely to increase, the Japanese and EC shares of Canadian trade have remained remarkably stable and are unlikely to rise significantly in the next few years.

45. It seems unlikely that Ottawa will go so far as to discourage future US investment, although more stringent government controls may be adopted as an appeasement to growing economic nationalism. Canadian concern about the switching to the United States of decision-making in vital industries because of their domination by American companies seems misplaced. US-owned firms are more capable than Canadian-owned firms of rationalizing their Canadian production. The Trudeau government, however, will probably try to prevent foreign takeovers in the "priority sectors," and vigorous nationalist thrusts will undoubtedly continue as Canada seeks a more distinct identity.

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There is little question but that Quebec's present government is not only willing but also eager to accept US investment. Even the platform of the moderate separatists' party provides for continued American investment after separation.

47. The Canadians probably will seek even closer trading ties with the United States where this promises more efficient industry. Ottawa favors additional sectoral free trade agreements -- permitting free trade in specified product categories -- similar to the agreement negotiated for automotive products. Although some such agreements might benefit the United States, past

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experience suggests that the benefits are generally greater for the smaller partner.

48. The US trade balance with Canada is likely to remain in substantial deficit for some time, the amount depending largely on Canadian economic performance and where the Canadian dollar is eventually pegged. US petroleum and gas imports will probably increase rapidly, as will imports of other Canadian minerals and forest products. Imports of manufactures other than automotive products are also likely to increase -- in the absence of countervailing US pressure -- as Canadian efforts to rationalize\* industry and increase manufacturing exports are realized. One can reasonably expect the US balance on automotive trade to improve slightly, however, as the manufacturers restructure their production in response to growing US dissatisfaction with the large deficit that has developed.

49. The expected resurgence in the Canadian economy should result in a substantial increase in US exports. With unemployment intolerably high, Ottawa is resolved to stimulate output. Although data for the first quarter of 1971 show that Canada is not yet out of the recession, most forecasters predict a gradual recovery in the second half of 1971. As Canadian investment revives, capital goods exports, which constitute the bulk of US sales to Canada, should rise measurably. The resurgence in Canadian economic activity should be sustained at least through the mid-1970s because of the rapid growth in the labor force and a very high level of family formation. The appreciation of the Canadian dollar over the past year should also begin to make itself felt in terms of increased US exports. If the Canadian dollar is fixed much above US \$0.96, Canadian competitiveness in the manufacture of consumer goods may be impaired, and US exports of manufactures could increase significantly.

50. The balance on services, which has run consistently in the United States' favor, will

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\* For an explanation of this term, see paragraph 18.

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grow progressively larger so that a US surplus on current account will probably reappear, albeit at a lower level. Income on US investment in Canada has continued to grow despite the Canadian recession and should expand further with the expected recovery in the Canadian economy and the consequent improvement in profits. Growth in receipts from other services including transportation and travel should likewise accelerate.

51. Despite the expected improvement in the current account balance, the US basic balance with Canada will probably remain in substantial deficit, although much will depend on whether Ottawa imposes new restrictions on US capital. Renewed growth in the Canadian economy will probably induce a further increase in US direct investment, particularly in sectors where US firms or their Canadian subsidiaries face continuing pressure to increase their Canadian content. Growing US demand for Canadian raw materials and energy products, particularly oil and hydroelectric power, will lead to increased US investment in these sectors.

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## APPENDIX I

Canada's Foreign TradeIntroduction

Canada's economy, because of limited domestic markets, abundant natural resources, and proximity to the United States, is foreign trade oriented. Exports amount to 20% of GNP and about 60% of physical production, a higher proportion than in any other major industrialized country (see Figure 2). Canada, with a total trade of almost \$30 billion, is one of the world's leading trading nations.

Discussion

Because of its reliance on foreign trade, Canada has long advocated liberal, non-discriminatory trade policies. As an active member of the General Agreement on Tariffs and Trade (GATT), Ottawa has participated in all of the tariff negotiations sponsored by that organization. The Canadians operate with a three-column customs tariff: the lowest or preferential rates are reserved for the United Kingdom and other Commonwealth countries; US goods are accorded most-favored-nation (MFN) or middle rates; and the highest or general rates apply to countries with which Canada has no treaties or trade agreements.

Although many Canadian tariffs are low -- over 60% of US exports to Canada are tariff free -- Canada maintains very high tariffs on finished goods of a type manufactured in Canada. Levies on processed goods usually range between 15% and 20%. Other features of the tariff system are the seasonal rates applicable to fresh fruits and vegetables of a kind grown in Canada, and the special temporary duty free entry frequently accorded imported parts or materials incorporated into Canadian manufactures. Canada maintains relatively few non-tariff trade barriers. Agreements have been negotiated with suppliers of some products -- primarily textiles -- to voluntarily limit exports to Canada,

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and licenses are needed to import some other types of goods -- primarily agricultural.

The outstanding feature of Canada's foreign trade is its extraordinary dependence on the United States (see Figure 12). The total value of US-Canadian trade -- \$20 billion -- is many times greater than the value of trade between any two other countries in the world. The United States and Canada are each other's biggest customer. In 1970 the United States purchased 66% of Canada's exports and provided 71% of its imports.

The United States takes over 70% of Canada's exports of aircraft, lumber, and fertilizer; over 80% of Canada's exports of newsprint; over 90% of Canada's exports of motor vehicles, whiskey, and farm machinery; and 100% of Canada's exports of crude petroleum and natural gas. Although two-thirds of Canada's total trade is with the United States, only about one-fourth of US trade is with Canada. The value of US trade with Canada is still substantially greater than our trade with either the European Community (EC) -- \$15 billion -- or US trade with Japan -- \$11 billion. Indeed, it is equal to about 80% of both of these combined.

Canada has supplied the United States with minerals and energy products while the United States has supplied Canada with capital goods and advanced technology manufactures. Although the United States has traditionally enjoyed a trade surplus, US-Canadian bilateral trade has been in deficit since 1968. In 1970 the bilateral trade deficit exceeded \$1,350 million -- over \$100 million more than our bilateral trade deficit with Japan.

Canada derives substantial benefits from its US trade, but there is concern that the economy is too dependent upon the United States. Unfavorable economic developments in the United States can have a substantial adverse effect on Canada's export industries (the 1959 recession caused US imports from Canada to fall about 6.5% and cut sharply into many firms' profits), and US inflation translates into higher prices for Canadian

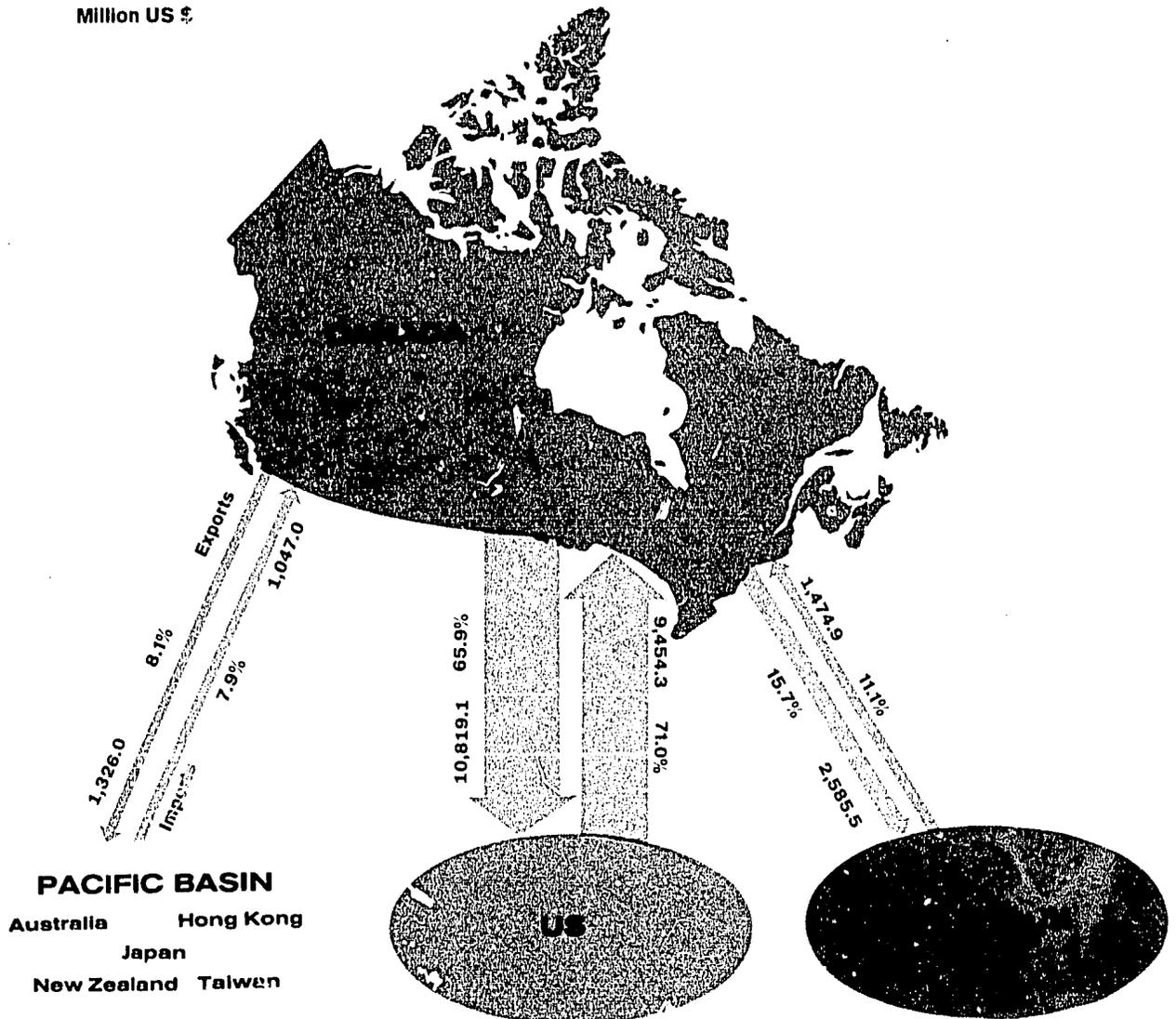
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**CANADA: Direction of Trade, 1970**

**Figure 12**

Million US \$



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imports and price increases in Canada. The Canadian Government is actively seeking alternate foreign markets; both to act as a countervailing influence to the United States, and to insulate Canadian industry from the ups and downs of the US economy.

Canada and the Pacific

Although the United States is Canada's dominant trade partner, Japan is the most dynamic. Since 1960 Canadian-Japanese trade has more than quadrupled; in 1970 Japan imported \$760 million of Canadian goods.

Canada exports industrial raw materials and grain to Japan in exchange for Japanese manufactures. Nearly three-fourths of Canada's total exports -- \$556 million in 1970 -- to Japan consist of minerals, wood and paper products, and grain. Increasing purchases of minerals by Japan, coupled with larger purchases of Japanese manufactures, could easily push the level of this trade into the \$3-\$4 billion range by 1975. Thus Japan will probably soon surpass the United Kingdom as Canada's second most important trading partner (see Table I-1).

Japan is the world's largest market for raw materials. Demand for commodities needed by Japan's rapidly expanding industries will probably double in the next five years. Canada, with its rich mineral resources, is an obvious source to satisfy this demand. Japanese investment in Canada is growing as Tokyo attempts to insure stable and long-range supplies. Canada currently provides the following proportions of Japan's total imports of selected raw materials: asbestos, 52%; pulp, 52%; coking coal, 5%; nickel, 8%; molybdenum, 28%; aluminum, 30%; copper, 15%; zinc, 24%; and lead, 56%. Canada's importance as a supplier of these items is likely to grow over time.

Major Japanese exports to Canada include textile yarn and fabric, steel, electric and non-electric machinery, transport equipment, and clothing. Although Japanese sales are small compared with those of the United States, they are

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growing rapidly in absolute terms. As yet, however, Japan has been unable to cut into the US share of Canadian imports. Since 1965 US exports to Canada have grown as a percent of Canadian imports while Japanese penetration has remained virtually unchanged.

There are several probable reasons why Japan has not enlarged its share of the Canadian import market. First, the Canadian market is small and scattered compared to the US market and Japan has concentrated its worldwide marketing efforts in the United States. Second, US exports are concentrated in high-technology manufactures and intermediate goods that face low tariffs. Japanese sales are focused on assembled products and consumer goods, which, because of Canada's desire to develop its own industry, face high -- and in many cases, prohibitive -- tariffs. Japanese exports to Canada consequently lag behind Canadian exports to Japan. The share of the Canadian import market, by selected supplier, is given in the accompanying tabulation.

	Percent					
	1965			1969		
	<u>United States</u>	<u>European Community</u>	<u>Japan</u>	<u>United States</u>	<u>European Community</u>	<u>Japan</u>
Total imports	70	6	3	72	6	4
Textile yarn and fabric	45	10	11	43	10	13
Steel	51	24	9	61	12	12
Non-electric machinery	85	4	1	84	5	1
Electric machinery	30	6	4	76	6	8

Australia and New Zealand, Canada's other major trading partners in the Pacific, account for only 1.5% of Canada's total trade. Although trade with both countries has grown steadily, this trade is still only marginally important. Australia, however,

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is Canada's second largest market for machinery and transport equipment, and Canada also sells it about \$50 million worth of wood and paper products and some minerals.

Since the fall of 1968 the United States has induced other countries to operate a voluntary export restraint program for frozen beef. Although Canada is an important supplier, it has not participated in the program. The intent of the US restraint program has been circumvented as imports of beef from Australia and New Zealand into Canada have freed increasing quantities of Canadian beef for export to US markets. The United States favors either restraint of Canadian beef exports to the United States or restraint of imports from Oceania, which would tend to have the same effect. Canadian beef sales to the United States in 1970 were \$45 million, a sharp increase over the 1968 level of \$12 million. An exportable surplus was created by the import of \$55 million of beef from Australia and New Zealand in 1970, vis-a-vis imports in 1968 of only \$9 million.

Canada, the United Kingdom, and Europe

The United Kingdom is Canada's second largest trading partner. Although Canadian-UK trade exceeded \$2 billion for the first time in 1970, this trade was stagnant throughout the 1960s. In 1960 the United Kingdom accounted for 14% of Canada's total trade, but by 1970 the figure had fallen to 7%. Canada's leading exports to the United Kingdom are grain, minerals, and wood and paper products. Because the demand for these primary products is closely linked to the level of British economic activity, the United Kingdom's lagging growth rate has inhibited export sales. Canada traditionally imports industrial goods from the United Kingdom, but growing Japanese and EC competitiveness has caused a shift in Canadian purchasing patterns.

We believe UK membership in the EC will probably have only a slight adverse effect on UK-Canadian trade. Many of Canada's raw material and industrial exports will be unaffected by the switch to the Common External Tariff, while several exemptions will apply to others. Special

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access to the UK market will be permitted for 12 industrial materials; Canada is a major supplier of nine of these: aluminum, lead, zinc, newsprint, wood pulp, plywood, phosphorous, ferrosilicon, and silicon carbide. These nine account for 20% of Canada's exports to the United Kingdom. Agreement permitting special access for alumina should be reached soon. Canada's agricultural exports to the United Kingdom -- some \$250 million in 1969 -- may be hurt if London implements the EC's present protectionist Common Agricultural Policy. Although Canada exports hard wheat which is not directly competitive with the soft varieties grown in Europe, increased grain prices may depress total demand for all types of wheat. EC accession would eliminate the tariff preference the United Kingdom receives in the Canadian market. This, and the continuing deterioration in the UK's international competitiveness, will make it more difficult for the United Kingdom to maintain its market share.

Canada hopes to expand its trade with the EC in order to reduce its dependence on the United States. Canadian-EC trade has increased 1.5 times in the past decade, and should exceed \$2 billion in 1971. The EC's dynamic growth has stimulated demand for Canadian minerals, and prospects for future minerals sales are bright. Canada, however, would like to export more manufactures and processed materials, but the EC tariff policy and productive capabilities of the member countries will make it difficult for Canada to increase rapidly its sales of manufactures in this market.

Canada's imports from the EC are typical of its imports in general: steel, industrial machinery, motor vehicles, textiles, chemicals, and instruments are the major import categories. EC sales of these items are competitive with US exports, but as with Japan, the EC has not made the effort to erode the United States' share of the Canadian import market. EC exports in 1970 accounted for 6% of Canada's total imports, the same share as in 1965.

The prospect of EC enlargement has caused concern in Canada. The EC is the world's largest trading entity, and enlargement could bring over

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half of the 91 GATT members into membership or association with the EC. EC trade preferences would place barriers in the path of Canadian export expansion and geographic diversification of trade.

The EC view is that the Canadians have greatly exaggerated the impact of enlargement. Total EC imports have doubled since 1958, and the average level of the Common External Tariff is lower on industrial goods than is the US tariff. Moreover, the dynamics of growth in an enlarged EC could provide larger markets for Canadian goods because of expanding import needs. It is unlikely, however, that enlargement itself will provide sufficient additional import demand to offset increased tariff barriers and the loss of preferences faced by Canadian exports. To counteract any adverse impact on its exports, Canada is working in GATT to maintain the momentum of trade liberalization, and is pressing for another major round of tariff negotiations.

Canada and the Developing Countries

Canada's exports to the less developed countries (LDCs) increased by 42% in 1970, giving Canada an unusual bilateral trade surplus with the group. The strong export growth pushed Canadian-LDC trade over the \$2 billion mark for the first time. Exports to the developing countries are atypical of Canadian exports in general -- although wheat, minerals, and paper are major exports, Canada also sells large quantities of industrial machinery, telecommunications apparatus, motor vehicles, aircraft, and other advanced manufactured products.

Imports from the developing countries consist primarily of petroleum, agricultural products, and raw materials. Notably petroleum for eastern Canada accounts for over 40% of all Canadian imports from the LDCs. (Venezuela provides over 60% of all petroleum imports; Iran and Nigeria are major suppliers too.) Other important import commodities are fruit, sugar, coffee, oilseeds, cotton, and bauxite. Textile products are the only manufactured goods of significance imported from the developing countries.

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The LDCs have pressed for a system of tariff preferences since the first meeting of the UN Conference on Trade and Development (UNCTAD) in 1964. In 1969 Canada submitted preference proposals to UNCTAD which call for a reduction in tariffs on eligible manufactured and semimanufactured goods to a level 33% below the post-Kennedy-Round MFN rate or to the level of the British preferential tariff, whichever is lower.

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Canada and the Communist Countries

Canada's recognition of the People's Republic of China and Prime Minister Trudeau's recent trip to Moscow highlight Canada's efforts to improve trade and political relations with the Communist countries. The sale of \$235 million of wheat to the USSR in June 1971 and China's exclusion of Australia as a grain supplier in favor of Canada, testify to the commercial success of these initiatives. The visit of Jean Luc Pepin, Canada's Minister of Trade, to Peking in June-July 1971 is likely to lead to further increases in trade with Communist China.

Canada's trade with the Communist countries (currently about 1% of Canada's total trade) hinges on Soviet and Chinese demand for Canadian wheat -- in 1969, exports to all Communist countries totaled \$140 million, of which \$120 million was wheat. Wheat usually accounts for 85% to 90% of Canada's exports to the Communists; these sales have been very beneficial to Canada because they facilitate the profitable disposal of its chronic grain surplus. Communist exports to Canada are similarly concentrated in a few commodity groups, with textile fibers, yarn, fabric, and clothing accounting for the bulk of sales.

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If Canadian-Communist trade is to expand, however, new export and import commodities must be found. Grain exports depend largely on availabilities in the importing country, and although Canada is currently the favored supplier for both China and the USSR, these sales are subject to great fluctuation -- for example, exports to the USSR plunged to \$9 million in 1969 from \$83 million the previous year. Canada is reluctant to see textile imports expand much further. It is unlikely that a substantial trade in advanced manufactures will soon develop since Western Europe, Japan, and the United States can satisfy either Canadian or Communist needs with greater ease than can the partners in Canadian-Communist trade.

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Table I-1  
Canada: Trade with Selected Partners a/

	Million US \$						
	1960	1962	1964	1966	1968	1969	1970
World							
Exports	5,332.4	6,066.5	7,797.6	9,816.2	12,746.7	14,066.3	16,418.2
Imports	5,663.2	5,851.8	6,944.2	9,096.8	11,356.1	13,055.5	13,307.5
Balance	<u>-330.8</u>	<u>214.7</u>	<u>853.4</u>	<u>719.4</u>	<u>1,390.6</u>	<u>1,010.8</u>	<u>3,110.7</u>
United States							
Exports	2,912.4	3,646.1	4,226.8	6,050.4	8,724.2	10,111.0	10,819.1
Imports	3,811.1	4,024.3	4,791.5	6,574.8	8,297.1	9,462.9	9,454.3
Balance	<u>-898.7</u>	<u>-378.2</u>	<u>-564.7</u>	<u>-524.4</u>	<u>427.1</u>	<u>648.1</u>	<u>1,364.8</u>
Japan							
Exports	184.2	201.6	308.0	365.6	562.7	579.2	760.2
Imports	113.9	117.1	161.8	234.1	331.1	458.5	556.6
Balance	<u>70.3</u>	<u>84.5</u>	<u>146.2</u>	<u>131.5</u>	<u>231.6</u>	<u>120.7</u>	<u>203.6</u>
United Kingdom							
Exports	953.5	859.7	1,119.1	1,047.0	1,133.6	1,029.8	1,432.1
Imports	607.2	526.7	532.2	596.4	643.9	731.6	705.1
Balance	<u>346.3</u>	<u>333.0</u>	<u>586.9</u>	<u>450.6</u>	<u>489.7</u>	<u>298.2</u>	<u>727.0</u>
European Community							
Exports	456.4	431.3	524.6	596.9	706.2	787.4	1,153.4
Imports	301.9	312.8	376.6	509.4	612.0	730.0	769.8
Balance	<u>154.5</u>	<u>118.5</u>	<u>148.0</u>	<u>87.5</u>	<u>94.2</u>	<u>57.4</u>	<u>383.6</u>

Table I-1

Canada: Trade with Selected Partners a/  
(Continued)

	Million US \$						
	1960	1962	1964	1966	1968	1969	1970
European Community (Continued)							
Of which:							
Germany							
Exports	172.8	168.6	201.4	166.2	215.0	259.6	371.6
Imports	103.9	131.9	158.0	217.6	276.5	328.1	355.2
Balance	<u>68.9</u>	<u>36.7</u>	<u>43.4</u>	<u>-51.4</u>	<u>-61.5</u>	<u>-68.5</u>	<u>16.4</u>
France							
Exports	75.8	55.3	75.5	80.2	77.9	119.9	150.1
Imports	51.7	52.4	64.0	98.6	112.6	142.2	151.7
Balance	<u>24.1</u>	<u>2.9</u>	<u>11.5</u>	<u>-18.4</u>	<u>-34.7</u>	<u>-22.3</u>	<u>-1.6</u>
Italy							
Exports	71.0	70.4	58.7	107.0	122.9	125.3	179.5
Imports	44.2	48.5	62.6	80.2	106.0	130.6	138.5
Balance	<u>26.8</u>	<u>21.9</u>	<u>-3.9</u>	<u>26.8</u>	<u>16.9</u>	<u>-5.3</u>	<u>41.0</u>
Australia							
Exports	102.8	99.5	138.7	110.3	177.1	156.0	192.4
Imports	36.6	42.2	55.7	55.1	70.3	89.0	140.2
Balance	<u>66.2</u>	<u>57.3</u>	<u>83.0</u>	<u>55.2</u>	<u>106.8</u>	<u>67.0</u>	<u>52.2</u>

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Table I-1  
 Canada: Trade with Selected Partners a/  
 (Continued)

	Million US \$						
	1960	1962	1964	1966	1968	1969	1970
Less developed countries							
Exports	417.7	415.4	617.9	735.0	762.1	814.3	1,157.8
Imports	660.7	668.1	800.0	796.2	977.3	1,068.2	1,115.5
Balance	<u>-243.0</u>	<u>-252.7</u>	<u>-182.1</u>	<u>-61.2</u>	<u>-215.2</u>	<u>-253.9</u>	<u>42.3</u>
Communist countries							
Exports	54.3	186.8	568.8	536.5	277.9	141.6	271.4
Imports	16.8	21.7	34.0	69.0	92.6	95.5	82.8
Balance	<u>37.5</u>	<u>165.1</u>	<u>534.8</u>	<u>467.5</u>	<u>185.3</u>	<u>46.1</u>	<u>188.6</u>
Of which:							
Soviet Union							
Exports	8.5	3.1	292.8	296.5	82.8	9.1	97.2
Imports	3.4	1.7	2.6	10.8	20.0	11.4	8.8
Balance	<u>5.1</u>	<u>1.4</u>	<u>290.2</u>	<u>285.7</u>	<u>62.8</u>	<u>-2.3</u>	<u>88.4</u>
Communist China							
Exports	9.2	138.1	126.4	171.0	151.0	113.3	135.2
Imports	5.8	4.2	8.6	19.1	21.7	25.3	18.2
Balance	<u>3.4</u>	<u>133.9</u>	<u>117.8</u>	<u>151.9</u>	<u>129.3</u>	<u>88.0</u>	<u>117.0</u>

a. Exports and imports valued f.o.b.

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## APPENDIX II

Canadian Energy BaseIntroduction

Canada is second only to the United States in per capita energy consumption. Oil provides about 48% of Canada's total primary energy consumption; natural gas about 18%; hydro-electric power almost 25%; and coal the remainder. This general pattern is expected to continue during the next decade, although nuclear power may contribute as much as 5% in 1980.

Discussion

Canada is now our largest single foreign source of crude oil and the sole source of natural gas imports.\* Conversely, the United States is practically the sole market for these Canadian exports. Almost all oil and gas from Canada are imported by pipeline (see Figure 13). Interchanges of electric power have served to meet respective peak load demands, and trade in coal permits both countries to take advantage of reciprocal, local coal deficiencies and surpluses.

There are considerable opportunities for future trade expansion in energy components between the United States and Canada. The extent of this potential trade depends on policy decisions, including national security considerations, yet to be made by the two governments and could involve sizable capital expenditures.

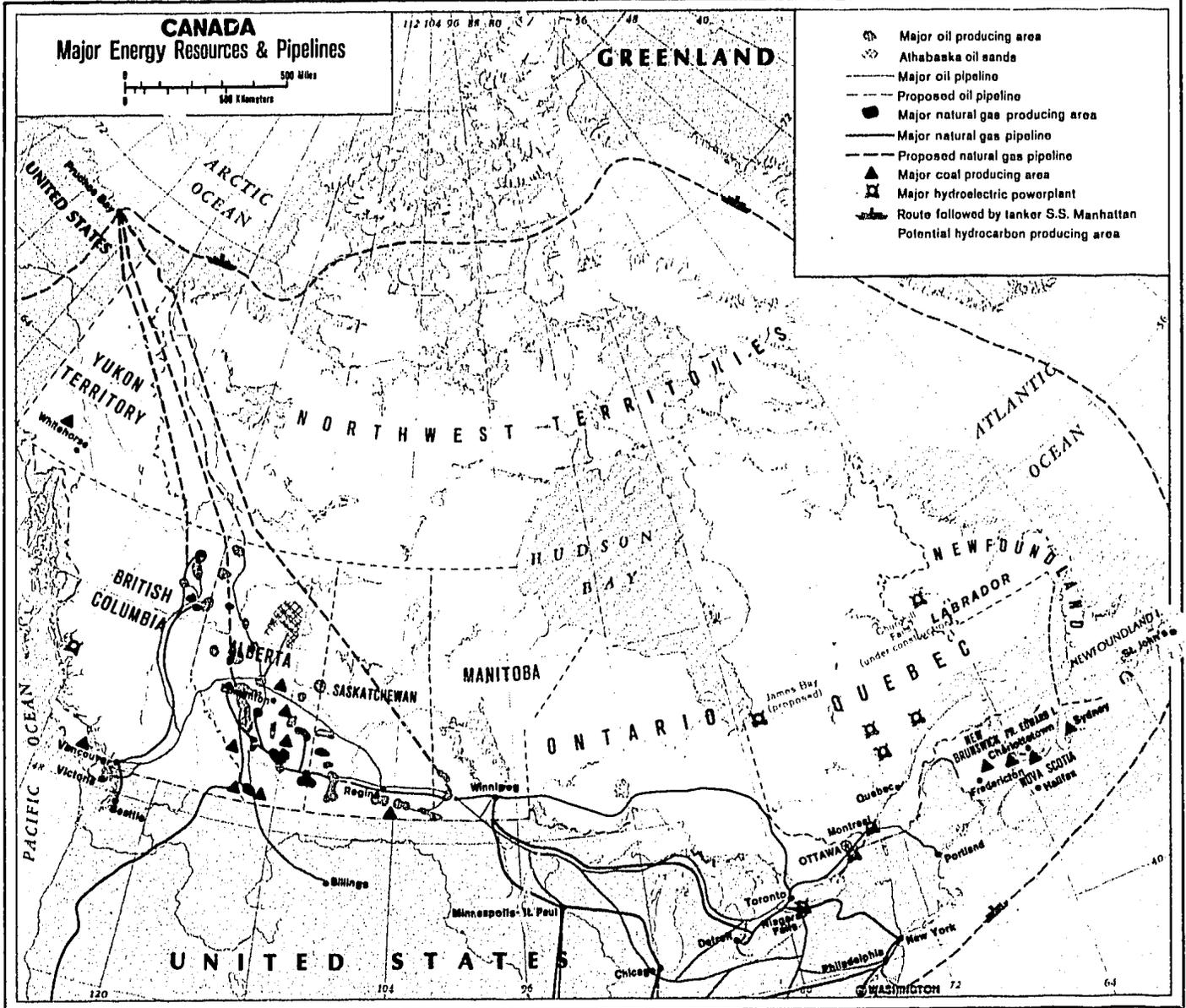
A major issue in this area under current discussion between the United States and Canada is that of a continental energy policy. The United States has proposed that a comprehensive understanding be reached on the development of trade in energy commodities between the two countries. Ottawa, however, believes that government involvement should be minimal and thus far has shied away from a formal bilateral energy agreement.

\* Venezuela provides, however, about 55% of total US oil imports, mostly fuel oil for the east coast.

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**Figure 13**



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**CONFIDENTIAL**Canadian Energy Resources and TradeOil and Natural Gas

Crude oil was found in Canada over a century ago, but not until the 1947 discovery of large oil and gas reserves at Leduc, Alberta, did petroleum begin to assume a major place in the economy. The Leduc find sparked development spending that has involved a cumulative investment of over \$15 billion in Canadian oil, much of it by subsidiaries of US oil companies.

Crude oil has since become Canada's single most valuable mineral asset, with 1970 output worth about \$1.1 billion. Natural gas production had a value of \$333 million, and natural gas liquids (liquid hydrocarbons extracted from natural gas) added \$150 million more to bring the total value of petroleum output to almost \$1.6 billion in 1970.

Oil production increased an average of more than 20% annually during the 1950s. In the 1960s, production increased an average of about 10% annually so that Canada's share of total Free World oil output was maintained at about 3%.

Natural gas production came into its own in the late 1950s and has increased an average of 13% annually during the last decade. Gas production\* was about 4.6 billion cubic feet per day in 1970 -- equivalent to over 800,000 barrels per day (b/d) of crude oil. Only about 15% of the gas was produced in association with crude oil, the remainder came from fields containing only gas. Canadian gas represented about 6% of the Free World total; US gas production was almost 80%.

Most of Canada's oil and gas fields are in Alberta, with Saskatchewan second in terms of oil, and British Columbia second in terms of gas. Canadian oil demand, however, is concentrated in the eastern provinces, mainly in Ontario and in Quebec, far removed from the major producing areas. Canada's oil supply and demand for 1970 is shown in Table II-1.

\* *Excluding gas reinjected into deposits, flared, or otherwise wasted.*

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Table II-1

Canada: Oil Supply and Demand, by Province  
1970 a/

	Thousand Barrels per Day
<i>Supply</i>	2,235
<u>Crude Oil</u>	<u>2,035</u>
<u>Domestic Production</u>	<u>1,465</u>
British Columbia	80
Alberta	1,115
Saskatchewan	250
Manitoba	20
<u>Imports</u>	<u>570</u>
Quebec	
Atlantic Provinces }	570
<u>Products</u>	<u>200</u>
<u>Imports</u>	
Ontario }	20
Quebec }	
Atlantic Provinces	180
<i>Demand</i>	2,235
<u>Domestic</u>	<u>1,495</u>
British Columbia and Yukon Territory	140
Alberta	
Saskatchewan	
Manitoba	
Northwest Territories }	190
Ontario	485
Quebec	490
Atlantic Provinces	190
<u>Exports</u>	<u>740</u>

*a. Preliminary.*

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The geographical imbalance in Canadian oil supply and demand led to a national oil policy in 1961. This policy restricted crude oil imports to markets east of the Ottawa Valley -- that is, Quebec and the Atlantic Provinces. It succeeded in its aim to protect the Canadian oil industry from foreign oil that could be delivered to eastern Canada at prices lower than oil from Alberta, and to take advantage of the lucrative market in the US Midwest.

Although proved oil reserves more than doubled over the past decade, they only represent about 2% of total Free World reserves; the United States has 8%. Moreover, there has not been a major new oil discovery in Canada since 1965. Gas reserves correspond to about 5% of the Free World total; the United States claims about 25%. Based on 1970 production, the "year-life" index\* of reserves in Canada is 20:1 for oil and 30:1 for gas. Comparable figures for the United States are 10:1 for oil and 13:1 for gas.

Oil production is expected to increase at an average annual rate of some 6% during this decade compared with about 7.5% in the Free World and about 5% in the United States. Gas production may increase an average of about 13% annually.

Future growth of Canada's petroleum industry will come mainly from the sizable resources of oil and gas in the "Frontier" areas.\*\* During the past five years the search for oil has been gradually shifting from the Prairie Provinces to the Canadian Arctic and offshore East Coast regions. All of the major international oil companies and many smaller companies have major exploration programs underway in these regions. Despite limited success to date, the outlook for new oil discoveries in Canada's frontier areas is considered great but the risk capital needed is enormous. The areas with the greatest potential -- the Arctic and offshore East Coast -- are likely to

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\* Proved reserves divided by most recent annual production.

\*\* The West Coast offshore, the Arctic Islands and offshore, Hudson Bay, the Atlantic offshore, and the Gulf of St. Lawrence.

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have the highest cost oil to find and produce. Forecasts of the Canadian oil industry's capital requirement over the next decade vary between US \$15 and \$25 billion. Much of this capital probably will originate from US sources.

US imports of Canadian crude oil were about 115,000 b/d in 1960 (see Figure 8). By 1970 they had exceeded 700,000 b/d and supplied about 5% of the total US demand for oil. Canadian oil is economically attractive to refiners in the oil deficient areas of the Far West and upper Midwest near the Canadian border. The delivered cost to these areas varies between 10 and 70 cents per barrel less than alternative sources.

Imports of natural gas from Canada into many northern tier states -- from the Pacific to the Atlantic -- were about 2 billion cubic feet per day in 1970, approximately 45% of total Canadian gas sales. This volume of gas corresponds to about 400,000 b/d of crude oil. Although the energy represented by this gas was small in terms of US total energy demand it corresponded to about 15% of Canada's total crude oil and natural gas sales.

US oil and gas reserves have not kept pace with demand in recent years and oil production in the "lower 48 states" is expected to peak in 1972 or 1973. Alaska crude will not make a substantial contribution before 1976. Industry forecasts indicate that the United States will need imports of 6 million-7 million b/d of oil in 1975 and at least 10 million b/d in 1980.

The opportunity for a substantial increase in Canadian oil sales to the United States in the next 10 years is clear. Somewhat less clear are the short-term supply prospects. The Canadian National Energy Board (NEB) estimated in 1969 that the maximum amount of crude oil available for export would be 1.1 million b/d in 1975 and 1.6 million b/d in 1980. Substantial investment will be required to find new oil reserves and increase output from existing fields. Similarly, the pipeline system is fast reaching its capacity. The current expansion program, which may be completed by the end of 1972, will raise capacity of pipelines to the United States to just over 800,000 b/d, with the remaining 500,000 b/d going to Canadian users. This marks

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the systems ultimate capacity. A new pipeline system will have to be constructed to significantly increase oil shipments to the United States, but action to raise both production and transport capacity awaits agreement between the two governments on the authorized level of oil trade.

It is US policy to import as much Canadian gas as possible though natural gas exports to the United States face similar transport limitations. By itself this policy probably would provide sufficient incentive for the Canadian gas industry to expand necessary exploration activities and transport facilities. The problem is that Ottawa is becoming increasingly concerned that too much of its gas resources are being committed to the United States. In late 1970 the National Energy Board (NEB) approved applications to increase Canada's natural gas exports to the United States by almost 50% during the next 15-20 years. Nevertheless, the approvals were substantially lower than those requested and one application was turned down. Moreover, the NEB warned that the discovery rate for new Canadian gas reserves will have to be stepped up markedly if the gas industry is to meet future demand growth, particularly in the US market. One-third of Canada's current proved gas reserves are already committed to the United States under long-term contract.

Tar Sands

In addition to Canada's conventional crude oil resources there is a truly enormous deposit of tar and heavy oil sands located at Athabasca in north-eastern Alberta. Recoverable reserves at these deposits are estimated to be 300 billion barrels of oil, dwarfing the estimates of ultimate recoverable reserves of conventional crude oil resources.\* Currently there is one plant in operation extracting about 45,000 b/d of oil from tar sands and another with a capacity of 125,000 b/d is in the planning stage. Much of the technology involved is still in

\* *Oil shale deposits in the United States are estimated to contain at least 1 trillion barrels of recoverable oil; conventional Mid-east reserves are estimated to be about 330 billion barrels.*

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the experimental stage and the huge capital investment needed per barrel of oil output has kept costs uncompetitive with conventional crude oil. Although the recent increases in Free World oil prices may close the gap, conventional sources of crude oil probably will continue to have a competitive advantage through much of this decade. The degree to which this resource will be exploited in the future will depend to some extent on the success of exploration for crude oil in the frontier areas and on additional economies of scale in oil sand development that are anticipated with experience and experimental work now in progress.

### Coals

Canadian coal production declined during the 1950s, then stabilized in the 1960s, and will increase significantly in the 1970s. During the past decade, output averaged about 10 million metric tons annually; this was only half the 1949 level when the railroads and other consumers had not yet converted from coal to oil. Recently, however, the growing demand for metallurgical coke for Japan's steel industry has given Canada's coal industry a strong stimulus. Contracts signed last year call for exports of over 160 million tons of coal to Japan over the next 15 years and efforts are being made to revitalize the country's coal industry in the west. Coal production is now expected to hit 24 million tons in 1975 and exports are expected to reach more than 14 million tons compared with only 1.5 million tons in 1969.

Canadian coal deposits are predominantly bituminous with some lignite. Coal is used primarily to generate electric power and secondarily in the metallurgical industry. Western Canada now accounts for about 60% of total production and its share should exceed 85% in 1975. Coal production in eastern Canada will decline in absolute as well as in percentage terms.

Canada is a net coal importer. In 1969 it imported almost 17 million tons from the United States. That part of the large demand for coal in eastern Canada which exceeds local production is filled by US exports -- the small surplus currently produced in western Canada is exported to Japan.

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There will be a substantial increase in eastern Canada's demand for US coal during the 1970s as both industrial and electric power needs increase in the face of declining local production. The planned export of western Canadian coal to Japan in the current decade will meet only part of Japan's growing needs and it is likely that the level of such exports will not affect US coal exports to Japan.

### Electric Power

Electric power production in Canada grew from 115 billion kilowatt hours in 1960 to 207 billion kilowatt hours in 1970, an annual average increase of 6% -- only slightly less than the United States. A similar growth is projected for the next decade. Canada's electric power production is currently almost 12% of US output.

Most Canadian generating facilities are in the east, with Quebec and Ontario containing over 60% of the total. Water power is still the main source of electric power in Canada but its share has declined over the years as new, low-cost sites became scarce. The share of electricity generated by water power fell from 90% in 1950 to about 70% last year and will probably drop below 60% by 1980. Thermal sources -- that is, coal, oil, and natural gas -- currently account for the remainder (see Table II-2). Over the next decade, nuclear and to a lesser extent conventional thermal generation are expected to grow much faster than hydroelectric. Coal is by far the most important conventional fuel -- firing more than 65% of Canada's thermal generating capacity.

Canada and the United States carry on a trade in electricity with Canada usually being a net exporter. Power grids permit electricity to be moved across the border with great flexibility to meet peak demands in either country. During shortages in the United States in September 1970 the Ontario Hydro Company diverted 558,000 kilowatts of its capacity, mostly from its Niagara Falls plant. A 320,000-kilowatt-capacity grid, opened in New Brunswick in October 1970, is available for transmission to Maine and thence to the New England Power Pool.

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Table II-2

Canadian Electricity Supply  
by Source of Generation  
1970 a/

	Billion KWH
Hydro	<u>145.0</u>
Thermal	<u>62.0</u>
Of which:	
Coal	40.0
Oil	8.0
Natural gas	14.0
Nuclear	Negl.
<i>Total</i>	<u>207.0</u>

*a. Preliminary.*

Quebec Province, at a cost of perhaps \$6 billion, is considering the construction of one of the world's largest hydroelectric projects along several rivers that flow into James Bay, 500 miles north of Montreal. If completed, this project might supply the power-short Northeast United States with a considerable quantity of power. Claims have been made that eventually the total generating capacity of this project could reach 10 million kilowatts, equal to about 25% of Canada's present electric generating capacity. In the 1980s, if the project is undertaken, as much as half of its electricity might be delivered to the United States. Deliveries of such a large block of power from James Bay would mean constructing 300 miles of direct current transmission lines from the Montreal area southward through New York State to Westchester County and New York City. However, the tremendous cost of the project and the sociological and ecological disturbances it will cause are major obstacles to its initiation.

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A large hydroelectric project is currently under construction at Churchill Falls in Labrador, Newfoundland. The \$1 billion scheme will become operational in 1972 and is expected to reach its full capacity of 4.5 million kilowatts in 1976. Production from Churchill Falls will largely be transferred to Ontario and New Brunswick as well as to New York City, 1,000 miles away.

**Continental Energy Policy -- The Current Issue**

The concept of a "continental" or "common" energy policy between the United States and Canada, originally proposed over 20 years ago, was given renewed impetus by the Alaskan North Slope oil discoveries in 1968 and impending US energy supply shortages. In recent discussions, the United States has been the major proponent of a bilateral understanding on energy policy. The concept, however, has run up against political problems in Canada, and near-term prospects for a formal agreement seem dim.

The general Canadian view is that energy trade between the two countries should be governed primarily by economic factors, and that apart from the activities of regulatory agencies, government involvement should be minimal. The United States seeks a comprehensive bilateral understanding that would assure supplies of oil and gas. This goes beyond mere reliance on the expectation that Canadian exports of energy commodities to the United States will automatically grow as required.

Oil trade policy was discussed at the most recent US-Canadian Cabinet meeting on economic affairs in Ottawa in November 1970. The Canadian position was that Washington should lift all restrictions on imports of Canadian oil. In March 1970 Canadian crude oil exports to the United States were placed under mandatory import quotas after more than a decade of being subjected only to informal agreements between the two countries. The 1971 quota limits Canadian crude oil exports into upper Midwest United States to 450,000 b/d. The Canadian view is that removal of the limitations would stimulate more exploration in Canada and lead to a greater resource base to provide spare capacity for both Canadian and US needs. The United States has offered to remove its restrictions on Canadian oil imports, but only in exchange

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for assurances that "normal" -- that is, the level existing prior to any interruption -- flows would be maintained during decreased deliveries of foreign oil to one or both countries.

The communique released at the end of the Ottawa meetings made two major points with regard to oil. It stated that "a prolonged and drastic disruption in overseas shipments to the East Coast of North America might require the diversion of some US produced oil to eastern Canadian markets to meet shortages there," in which case "it would be reasonable to expect that western Canadian supplies in excess of normal shipments would be available to offset US supplies diverted to Canada." The second point was that "for 1971, it is expected that pipeline capacity would need to be fully used and it was agreed that arrangements should be worked out quickly to permit, in subsequent years, full and unimpeded access to US markets of Canadian crude oil and petroleum products, surplus to Canadian commercial and security requirements."

Political opposition within Canada to closer ties with the United States through a common energy policy will probably inhibit a formal US-Canada energy policy in the near future. A more likely course of events is continuing negotiations regarding import plans for separate energy commodities and technical problems such as pipeline construction projects and deliveries of oil during supply emergencies.

A first step toward an informal common energy policy may be the proposed oil and gas pipelines from Alaska through Canada to serve the US energy market. Several studies -- one oil pipeline and three gas pipelines have been proposed -- are currently under way in Canada to determine the economic and environmental feasibility of constructing one or more of these pipelines. Each is estimated to cost \$3-\$4 billion and would take at least three years to complete. The Canadian oil industry is hopeful that these lines will be built thus stimulating the development of Canadian petroleum resources in the Northwest and Arctic regions. It appears likely that at least a gas pipeline will be built through Canada since it has a clear economic advantage over liquefaction of natural gas and subsequent transportation from Alaska by specially built tankers.

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Department of Interior  
Release & Declassification  
Instructions On File.  
Review Completed.

Construction of an oil pipeline through the Mackenzie Valley to Edmonton, Alberta, as an alternative to US oil companies' proposal for a Trans-Alaska line -- currently under review by the US Department of Interior -- is less certain. The Trans-Alaska line probably will be built unless ruled against by Interior; the oil companies have already made substantial financial commitments to this route and much of the pipe -- made in Japan -- is already on hand.

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## APPENDIX III

Canadian Metals and MineralsIntroduction

Canada is the world's third largest minerals producer after the United States and the Soviet Union. In 1970, metal and mineral production in the primary stage -- that is, before fabrication -- totaled \$5.5 billion, accounting for 7% of GNP and nearly one-third of Canada's total exports. About 60% of Canada's mineral production is exported, and since 1961, minerals -- including crude oil -- have made a major contribution to Canada's favorable balance of trade.

Discussion

Canada produces some 60 minerals in quantities that both satisfy domestic demand and provide an export surplus. Canada, however, has some notable mineral deficiencies. It imports all the tin, manganese, and chromite used by its steel industry, and all the bauxite and alumina processed by its large aluminum industry. Canada also imports all of its industrial diamonds. Coal output falls short of needs and, although more than half of Canada's crude petroleum output is shipped to the United States, nearly a like amount is imported.\*

Metals and minerals output has grown an average of 9% annually since 1960, or twice as fast as GNP (see Figure 14), with the metals accounting for about 55% of the sector's production. The most important single mineral is crude oil -- 1970 production at \$1.1 billion -- followed by nickel, copper, iron ore, and zinc.

Canada's mineral wealth and political stability have attracted foreign development capital. The

\* For a detailed discussion of Canadian-US trade in petroleum, see Appendix II, "Canadian Energy Base."

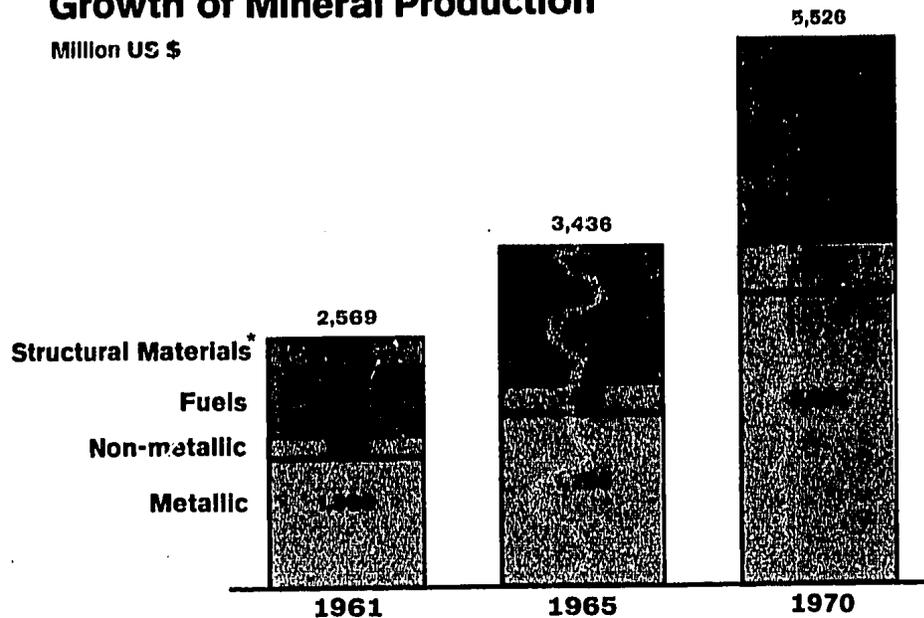
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## CANADA: Growth of Mineral Production

Million US \$

Figure 14



\*Clay products, cement, lime, sand and gravel, and stone

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industry is almost entirely in private hands. There are only three important public ventures: Eldorado Nuclear, Ltd., completely owned by the federal government; Panartic Oils, Ltd., in which the federal government has a direct financial interest, and SOQUEM (Quebec Minerals Corporation), an exploration company, wholly owned by Quebec province. Foreign investment has expanded considerably in recent years. About 60% of the assets in mining and smelting and more than 60% of the oil and gas industries are foreign owned, and this recently has become a contentious issue.\*

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**CONFIDENTIAL**Ferrous Minerals and Alloying Elements\*

Production of ferrous ores and metals -- \$1.5 billion in 1970 -- increased rapidly during the past decade. Canada ranks first among world producers of nickel; second in molybdenum, behind the United States; third in cobalt, behind Congo (Kinshasa), and the USSR; fourth in iron ore, behind the USSR, the United States, and France; and seventh in tungsten. Except for tungsten, output is more than adequate for domestic consumption.

Canada has substantial reserves of most raw materials and alloying ferrous metals except manganese, chromium, and possibly tungsten. Iron ore reserves -- possibly as much as 30 billion tons with an average 51% iron content -- are adequate for 300 years at current production levels. The principal deposits are in Labrador, Quebec, and Ontario, but there are also substantial deposits in British Columbia. Nickel deposits, located principally in the Sudbury area of Ontario and northern Manitoba, are large and adequate for many years at the current production rate. Nonetheless, ores from Australia, New Caledonia, and Venezuela, mined by Canadian companies, account for an increasing share of Canadian nickel metal output. Molybdenum ore is mined principally in British Columbia and Quebec. Cobalt is a byproduct of nickel-copper processing. (Canadian ferrous metallic ore deposits are shown on the map, Figure 24).

Steel Production

Canada's iron and steel industry, although small compared with the world's major producers, manufactures a broad range of quality products for domestic consumption, and is a small net exporter as well. During the past five years, steel output has grown 4.2% annually, or slightly faster than world production. In 1970, output reached 11 million tons, worth about \$1.6 billion.

\* Including nickel, molybdenum, manganese, chromium, tungsten, and cobalt, all of which are used by the iron and steel industry.

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The industry is highly efficient and employs the most modern technology. Basic oxygen furnace processing currently accounts for nearly 60% of steelmaking capacity, and its share is increasing rapidly. The industry also operates the world's most efficient and advanced open-hearth furnaces. Canada was a pioneer in installing continuous casting equipment and currently processes a greater percentage of its primary steel forms\* by this method than any other major producer. Canada also is able to obtain more rolled products from each ton of crude steel than can either the US or Japanese industries. The industry's efficiency is further enhanced by the fact that capacity is concentrated in four integrated plants, located in Ontario and Quebec. Together these plants produce 85% of national output and almost all of Canada's flat-rolled steel products.

In 1966 -- the latest year for which comparable cost data are available -- Canada had somewhat lower costs than the US steel industry, but higher costs than the Japanese. Unit labor costs in the Canadian steel industry were more than \$10 per ton under those in the US industry. Although Canadian labor productivity -- in terms of man-hours required per ton of rolled steel shipped -- was somewhat lower than in the United States, the difference was more than offset by lower hourly wage rates. Canadian labor productivity was considerably higher than in the Japanese industry, but hourly wage rates were more than three times higher. Since 1966, labor productivity in the Canadian industry has increased 4% annually compared with a 2.2% annual increase in the United States and a 12.2% annual increase in Japan. At the same time, hourly wage rates increased a total of 11% in Canada, 17% in the United States, and 20% in Japan. Consequently, in 1970, Canadian unit labor costs were roughly 10%-15% below those of the US industry and about twice those of Japan.

Current plans call for expanding steel capacity to 15 million tons by 1975. As most of the new capacity will be added to Canada's four existing large plants, additional economies of scale are

\* *Blooms, billets, and slabs, which are subsequently rolled into finished shapes.*

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likely to be realized. At the level of output planned for 1975, Canada will continue to be capable of meeting domestic needs and to have a substantial surplus for export.

Nonferrous Metals and Minerals

Canada, a leading producer of nonferrous metals, accounted for a substantial share of world output of a number of metals in 1970:

<u>Metal</u>	<u>Share of World Output (Percent)</u>	<u>Rank</u>
Zinc	23	4 <u>a/</u>
Copper	9	5
Lead	11	3
Silver	15	1
Platinum	14	3

*a. Fourth in production of zinc metal, but first in mine output.*

Canada is the world's third largest aluminum producer, although it imports all of its bauxite and alumina. Canada also produces sixteen other nonferrous ores and metals. Canadian production of nonferrous materials -- excluding aluminum output -- totaled \$1.4 billion in 1970, 25% of total mineral output.

The nonferrous smelting and refining industry is well developed. There are copper smelters in Manitoba, Ontario, and Quebec, and zinc and lead refineries in British Columbia, Manitoba, Quebec, and New Brunswick. About 85% of the copper, 40% of the zinc, and 60% of the lead ores produced in Canada are refined domestically -- the remainder being exported as concentrates. As is true with most of Canada's mineral production, the nonferrous industry is export-oriented. In 1970, Canada consumed only a little more than half of its refined copper output, 25% of its zinc, and 40% of its lead output.

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**CONFIDENTIAL**The Special Case of Uranium

During the late 1950s and early 1960s uranium oxide (U<sub>3</sub>O<sub>8</sub>) mining flourished under the impetus of US contracts and substantial US investment. Yearly output reached a peak of 14,414 tons -- valued at \$342 million -- then declined gradually to 3,380 tons in the late 1960s, when contracted deliveries to the United States were completed. In 1970, output was 3,638 tons valued at \$48 million. The uranium industry currently is experiencing a minor revival because of expanding demand for long-term supplies of nuclear fuel for generating plants. World demand is expected to rise to 80,000 tons by 1980, a threefold increase in Free World requirements. Exploration for new uranium ore deposits has been proceeding at an accelerated pace for the past two years.

Canadian officials have objected strongly to US restrictions that prohibit the use of imported uranium as feed for enrichment in US processing plants where the final product is destined for US consumption. This restriction was imposed in 1966 under the provisions of the Atomic Energy Act that require the maintenance of a viable US uranium industry. In 1968 the AEC published a notice of its intention to remove the restriction as soon as possible, indicating that this might be possible by July 1973 or earlier. Commissioner Tape of the AEC reaffirmed this intention to Prime Minister Trudeau during his official visit to Washington in March 1969. In December 1969, Commissioner Johnson outlined an AEC proposal for partial removal of the restriction on the import of uranium for enrichment. The AEC subsequently submitted a proposal to the Office of Management and Budget where it is still under review. The plan calls for import liberalization and is closely linked with plans to dispose of part of the US uranium stockpile.

Canadian Minister of Energy, Mines and Resources, J.J. Greene, has been publicly critical of US policy on uranium, citing it as a poor example of US-Canadian ability to coordinate policies in the energy field. The Canadians feel that US restriction is basically unfair, since it cuts off the principal market for a Canadian industry that the United States originally encouraged, and which is now

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operating at only about one-third of capacity. Although acknowledging that it has received general assurances, Ottawa feels that the United States should present a positive timetable for liberalization so Canadian mines can plan their future activity. Moreover, Ottawa argues that the US restriction is a nontariff barrier maintained in violation of the General Agreement on Tariffs and Trade (GATT).

Canada has had some success in selling uranium oxide to other countries. Since 1967, 33,000 tons have been sold to Japan with deliveries scheduled from 1969 through 1983. Small quantities also have been sold to the United Kingdom and West Germany, but on shorter delivery schedules. Canadian sales to Japan, however, are meeting increased competition from other countries, particularly South Africa, France, and the United States. More recently, Australia has become an important potential uranium supplier to the Japanese market.

**Nonmetallic Minerals**

Canada, in addition to fossil fuels, is a substantial producer of other nonmetallic minerals, ranking first in world production of asbestos, second behind the United States in gypsum and sulphur, and second behind the USSR in potash. Output of nonmetallic minerals, excluding fossil fuels, was \$896 million in 1970, divided about evenly between structural materials -- clay products, cement, lime, sand and gravel, and stone -- and other nonmetallics. Canada consumes very little of its major nonstructural, nonmetallic mineral production -- gypsum 25%, sulphur 21%, potash 8%, and asbestos only 1%. Exports of these four commodities alone, principally to the United States, amounted to nearly \$400 million in 1970. For further distribution of Canadian mineral exports, including asbestos and sulphur, see Table III-1.

**Canadian Mineral Trade**

Canada is one of the world's largest exporters of minerals and processed metals, exporting nearly 60% of its output. In the past decade, Canada's minerals exports grew 13% annually, reaching \$4.8 billion in 1970 (including \$847,000 in fossil fuels

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and \$329,900 in rolled steel). Minerals and metals are exported to some 90 countries. Although Canada consumes only about 40% of its output, it is not wholly self-sufficient. In 1970, Canada imported \$1.3 billion of mineral raw materials and processed metals, including fossil fuels and iron and steel. Net exports, however, were \$3.5 billion, an important contribution to Canada's overall favorable trade balance.

Importance of Canadian Mineral  
Trade with the United States

The United States is by far Canada's most important trading partner in minerals and metals. In 1970 the United States bought 50% of Canada's mineral exports and supplied 53% of its mineral imports. The net mineral trade balance of \$1.6 billion was in Canada's favor. This is not surprising, considering that a large segment of Canada's mineral industry has been developed with US capital, and many companies are partly or wholly owned subsidiaries of US firms.

US mineral production -- about \$25 billion in 1970 -- fell short of net consumption by about \$1 billion. In 1970, US imports of minerals and metals, excluding steel, were \$4.8 billion, of which 46% came from Canada. (Overall US imports of iron and steel were nearly double exports -- \$2.03 billion, compared with \$1.3 billion.) US deficiencies were greatest in petroleum and nonferrous metals; net trade with Canada accounted for nearly half the petroleum and three-quarters of the nonferrous metals shortfalls. As shown in the tabulation below, Canada had a favorable net balance with the United States in every category of mineral trade except solid fuels. All of Canada's coal imports in 1970 came from the United States -- 16.7 million tons valued at \$138 million.

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<u>Commodity Sector</u>	<u>Million US \$</u>			
	<u>US Imports</u>	<u>US Exports</u>	<u>Overall Balance</u>	<u>US Balance with Canada</u>
Metallic ores and scrap	1,100.0	938.2	-161.8	-329.9
Coal, coke, and briquets	21.6	1,600.0	1,578.4	144.5
Crude petroleum	1,425.6	18.4	-1,407.2	-621.8
Natural gas	293.2	62.6	-230.6	-192.4
Nonferrous metals	1,650.0	963.9	-686.1	-515.6
Nonmetallic minerals	284.9	319.1	34.2	-71.2
<i>Total</i>	<i>-4,775.3</i>	<i>3,902.2</i>	<i>-873.1</i>	<i>-1,586.4</i>

Imports from Canada provide a large share of US total imports and a substantial part of US consumption of a number of mineral commodities (see Figure 15).

Long-range projections of mineral consumption made by the Department of Interior indicate that the United States is destined to become increasingly dependent on imported mineral raw materials. They suggest that the deficit in US net consumption could increase to \$5 billion by 1975. Although the United States may be able to import more of its raw material needs from developing countries, dependence on Canadian exports will continue and will likely increase. But, the United States will face increasing competition for Canada's minerals from Japan and Western Europe -- regions that account for a small share of world production but consume a substantial proportion of world requirements.

#### Canadian Minerals in the Japanese Market

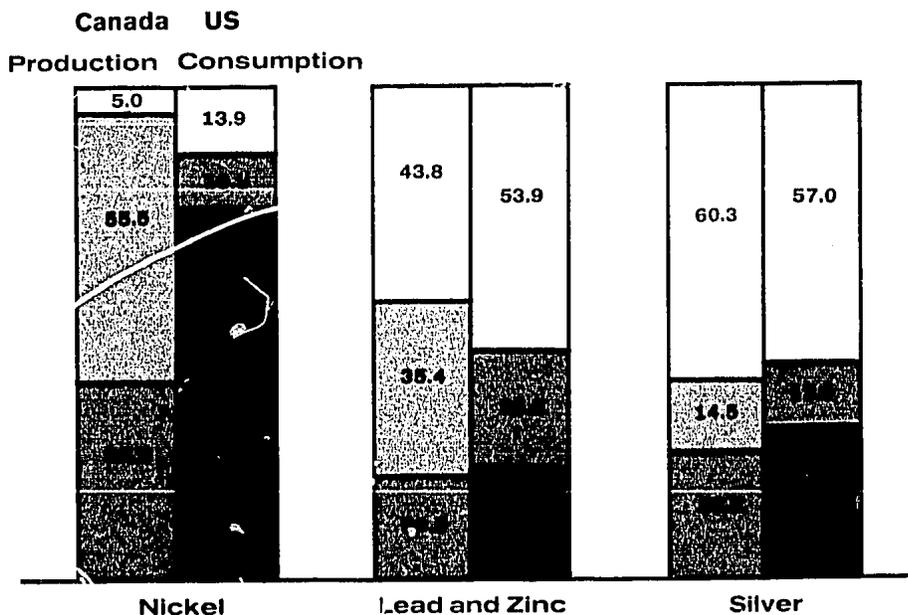
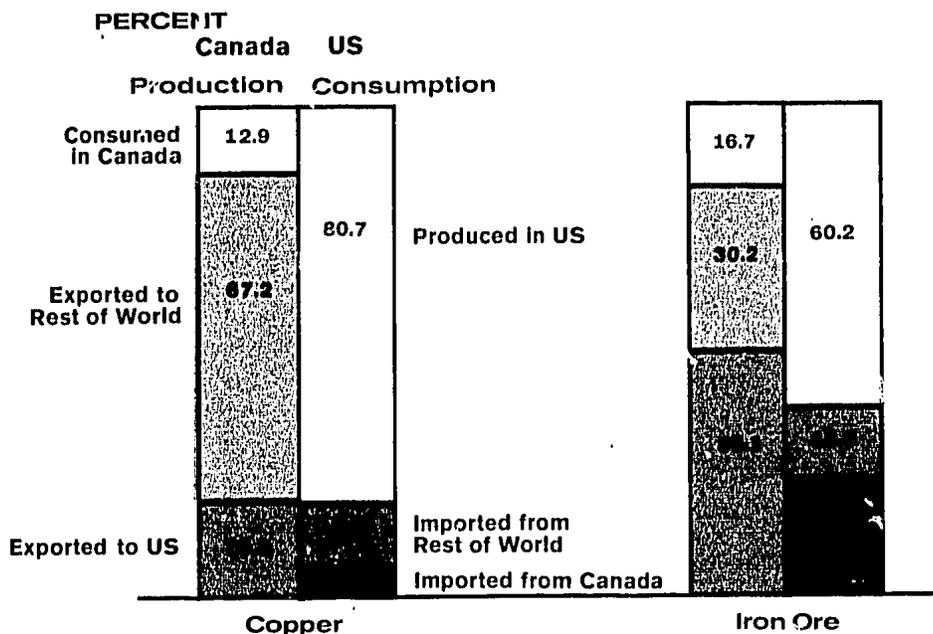
Canada's total exports to Japan have nearly quadrupled since 1962 with minerals replacing grain as the leading export category. In the early 1960s grain accounted for more than 40% of Canada's exports to Japan; today it constitutes only 13%. Minerals, however, have increased from only 26% of total exports 10 years ago to nearly 48% of total exports today. With a surge in industrial production in the 1960s, Japan has become the world's

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Figure 15

**CANADA and US: Mineral Supply and Consumption, 1969**



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largest importer of minerals. Canada was in an excellent position to supply some of these needs because of its growing mineral production, its relative proximity to Japan, and new port facilities capable of handling large bulk carriers. Canada's political and economic stability have encouraged the Japanese to enter into long-term contracts for the development and supply of mineral resources. Because of these factors, and its competitive mineral prices, Canada has become a major raw materials supplier for Japanese industry.

Canada's mineral exports to Japan have grown an average of 26% annually since 1962. Canadian mineral exports to Japan in 1970 totaled \$361.3 million vis-a-vis imports of \$72.1 million, of which rolled steel accounted for \$67.8 million. In 1970, Japan was the largest importer of Canadian copper and lead concentrates and coal, and also was a major importer of Canadian aluminum, asbestos, molybdenum concentrates, and pig iron.

Canadian mineral exports to Japan will grow rapidly and could reach \$1 billion by 1975. Japan not only has negotiated long-term contracts for the major raw materials it needs but is also investing in new mining development and, in some cases, has entered into joint ownership agreement with Canadian firms. Canada's share in Japan's 1970 imports of selected minerals and those scheduled for 1975 are shown below:

<u>Commodity</u>	<u>Canada's Share of Japan's Im- ports in 1970 (Percent)</u>	<u>1975 Exports to Japan (Thousand Metric Tons)</u>	<u>Increase over 1970 (Percent)</u>
Zinc concentrates	24	254	170
Lead concentrates	56	122	74
Copper concentrates	15	383	233
Iron ore	2	7,000	185
Coking coal	5	13,900	234

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### Canadian Mineral Development Policy

Natural resource administration is divided between the federal government and the various provinces. The federal government administers resources in the Yukon and Northwest territories and the offshore areas. Natural resource administration within provincial boundaries is the responsibility of the provinces. Although there are some variations in the several provincial mining laws,\* all encourage profitable mineral development and none restrict foreign participation or ownership. There are a few provisions in the federal law that limit foreign ownership in the development of oil and mineral rights in the territories and offshore areas.

Canada has attracted foreign capital for mineral development through tax exemptions, depletion allowances, and accelerated depreciation allowances. Profits from mining operations are not taxed by any province for the first three years. Moreover, a depletion allowance of 33-1/3% of profits is deductible for as long as the mine remains productive. Most buildings, machinery, and equipment in the mining industry can be depreciated at a rate of 30% annually, which is considerably higher than that granted other sectors of industry. Certain underground developments, such as shafts and haulageways, can be written off in the first year.

Canada has long recognized the importance of foreign investment to the development of its mineral industry. Foreign investment has supplied the necessary capital, particularly risk capital; assured markets; and provided management know-how, and sometimes new technology. In recent years, however, some Canadians have questioned the extent of foreign ownership, stressing the danger to Canadian economic interests where foreign control

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\* Ontario recently passed a law requiring that 51% of all ores mined in the province be processed in Canada. This provision, however, has been widely waived; thus far in 1971, 27 companies have been exempted.

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becomes too extensive.\* This theme was brought to the attention of all Canadians with the publication of the Watkins Report. The report prepared for the Privy Council in January 1968 presented specific proposals to ensure a stronger Canadian presence in the decisions of multinational corporations and to facilitate the development of large projects with Canadian capital. Although no direct action has been taken to implement recommendations in the report, except the recent introduction of a bill which would require fuller financial disclosure by companies operating in Canada, many of the report's conclusions are representative of the present thinking in Canada.

In March 1970 the government in Ottawa proposed restrictions on foreign ownership of uranium mines. The regulations would limit aggregate foreign ownership to 33% of any uranium property of established productive capacity, and only 10% of such a property can be held by one foreign investor or group of associated investors. They place no restriction on foreign ownership of companies engaged in uranium exploration. To date the new policy has yet to be implemented through legislation.

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Table III-1

Canada: Distribution of Exports  
of Selected Minerals  
1970

	<u>Million US \$</u>	<u>Per- cent</u> <sup>a/</sup>
<u>Metallic Ores and Concentrates</u>		
Iron ore	470	100
United States		64
United Kingdom		11
Netherlands		8
Japan		4
Others		13
Copper ore	197.9	100
Japan		74
Norway		16
United States		3
Others		7
Lead ore	32.3	100
Japan		51
United States		24
West Germany		12
United Kingdom		11
Others		2
Zinc ore	112.0	100
United States		36
Belgium-Luxembourg		23
United Kingdom		14
Japan		11
Others		16
Nickel ore	339.1	100
United Kingdom		38
West Germany		32
United States		18
Japan		7
Others		5

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Table III-1

Canada: Distribution of Exports  
of Selected Minerals  
1970  
(Continued)

	<u>Million US \$</u>	<u>Per- cent</u> <sup>a/</sup>
<u>Metallic Ores and Concentrates</u>		
<u>(Continued)</u>		
Molybdenum ore	58.4	100
United Kingdom		26
Japan		18
Netherlands		16
France		15
Others		25
Uranium ore	24.9	100
United States		65
United Kingdom		35
<u>Nonmetallic Minerals</u>		
Asbestos	240.3	100
United States		29
Japan		8
United Kingdom		7
West Germany		6
France		5
Australia		4
Others <sup>b/</sup>		41
Sulphur	41.1	100
United States		39
India		15
Australia		8
Taiwan		8
United Kingdom		6
Others		24

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Table III-1

Canada: Distribution of Exports  
of Selected Minerals  
1970  
(Continued)

	<u>Million US \$</u>	<u>Per- cent <sup>a/</sup></u>
<u>Processed Metals</u>		
Pig iron	33.9	100
United States		41
Japan		26
West Germany		12
Italy		9
Others		12
Aluminum	439.6	100
United States		37
United Kingdom		24
Japan		9
West Germany		4
Others		26
Copper	454.9	100
United Kingdom		35
United States		31
West Germany		12
France		5
Japan		1
Others		16
Lead	41.7	100
United States		45
United Kingdom		35
India		12
Others		8

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Table III-1

Canada: Distribution of Exports  
of Selected Minerals  
1970.  
(Continued)

	<u>Million US \$</u>	<u>Per- cent</u> <sup>a/</sup>
<u>Processed Metals</u> (Continued)		
Zinc	87.1	100
United States		39
India		7
West Germany		3
Japan		2
Others		49
Nickel	416.1	100
United States		60
United Kingdom		16
Netherlands		4
Japan		2
Others		18
Rolled steel	329.9	100
United States		69
Others		31
<u>Mineral Fuels</u>		
Crude petroleum	621.8	100
United States		100
Coal	27.9	100
Japan		90
United States		4
Belgium-Luxembourg		4
Others		2

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Table III-1

Canada: Distribution of Exports  
of Selected Minerals  
1970  
(Continued)

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	<u>Million</u> <u>US \$</u>	<u>Per-</u> <u>cent</u> <sup>a/</sup>
<u>Mineral Fuels (Continued)</u>		
Natural gas	197.3	100
United States		100

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- a. Distribution based on value of exports.*  
*b. Comprising 65 countries.*

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## APPENDIX IV

### The US-Canadian Automotive Products Agreement

#### Introduction

The January 1965 US-Canadian automotive products agreement was, in retrospect, an economic landmark. Under its aegis, bilateral trade in auto products increased almost 800% from less than \$705 million in 1964 to more than \$6 billion in 1970. Automotive trade accounted for less than 8% of total US-Canadian trade in 1964, but reached 30% in 1970. Because Canada's exports increased more rapidly than did corresponding US exports, the US bilateral account in automotive products shifted from a surplus of \$560 million in 1964 to a deficit of \$315 million in 1970. During these same six years the US overall trade balance with Canada went from a \$565 million surplus to a \$1,365 million deficit.\* The \$875 million swing in the auto trade balance explains 45% of the deterioration in the overall bilateral trade account. Put another way, the current automotive deficit is equivalent to about 25% of our current bilateral trade deficit. Because of the shift in the auto trade balance, the United States has intensified its efforts to remove the transitional arrangements designed to protect the Canadian auto industry during the early years of the agreement.

#### Discussion

Prior to the 1965 agreement, Canada's auto industry was an inefficient, miniature duplication of the US industry. Auto products produced by vehicle manufacturers in the United States and their Canadian subsidiaries typically supplied nearly 90% of the Canadian market. Canadian models were essentially the same as those produced in the United States. However, in 1964 Canada's population was only 10% as large as ours and its

\* For a discussion of the methodology employed in deriving these statistics, see Appendix XI, Methodology.

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GNP was only 7% as large. Consequently, firms in Canada were unable to produce the volume necessary to realize the economies of scale so important in the automotive industry. As a rule of thumb, unit costs decline rapidly when assembling a particular model until an annual output of about 125,000 units is reached. There are similar breaking points of 250,000 units for engine production and 600,000 for pressing operations. But total Canadian auto sales of American-type automobiles -- shared by three major and several minor producers -- were only 551,000 units in 1964.

Protected by tariffs, Canada's auto industry grew despite short and inefficient production runs. Prior to 1965, the Canadian tariff facing US exports of completed vehicles was 17.5%, for engines and certain parts 25%, and for other specified parts 17.5%. The actual degree of effective protection afforded Canada's automotive companies exceeded this 17.5% nominal rate. This was because parts could be imported duty free for assembly in Canada as long as the finished vehicle had at least 60% Canadian content. The rate of effective protection on the Canadian share of the finished vehicle was just over 33%.

The cost of maintaining Canada's inefficient automotive industry was borne by both consumers and workers, though the latter benefited from increased employment. Before the agreement, prices for Canadian automobiles equivalent to US models were between 10% and 17.5% higher than in the United States; this despite the fact that Canadian auto wages were only about 70% of the US level. In 1964 the industry employed approximately 800,000 workers and contributed about \$800 million -- about 8% -- to total Canadian industrial production. The average rate of return on capital invested in the auto industry, however, was in the same general range in Canada and in the United States.

The high cost of maintaining its auto industry, plus rapid increases in automotive imports, led Ottawa in October 1963 to institute an extended content-and-duty rebate program. For each dollar of Canadian content in any vehicle or part exported, a Canadian manufacturer could import one dollar's worth of new vehicles or parts duty free.

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This program was designed to rationalize the industry through specialization. At a minimum it would have reduced somewhat the Canadian auto trade deficit with the United States had it continued in force for a number of years. However, Canada's action conflicted with the provisions of Section 303 of the US Customs act of 1930, which requires that a countervailing duty be imposed on subsidized exports to the United States.

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The Agreement

The automotive agreement establishes duty free trade between Canada and the United States on most automotive products. It consists, in effect, of two parts. Part one is the inter-governmental agreement continuing in effect until abrogated following a 12-month notification period. Part two -- indispensable to launching Part one -- took the form of side conditions placed upon the American-owned, Canadian vehicle manufacturing subsidiaries by Ottawa.

Under Part one, only manufacturers in Canada who satisfy requirements stated in the agreement can import parts or vehicles from the United States duty free. The requirements in the agreement are:

(1) For each class of vehicle, each manufacturer in Canada must at least maintain the ratio that existed in 1964 between the value of Canadian assembled vehicles and the value of sales in the Canadian market -- in 1964, the assembly to sales ratio, in the aggregate for all manufacturers, was about 1.01 -- in other words, for every \$100 of their sales in the Canadian market, the manufacturers had to assemble in Canada vehicles worth \$101; and

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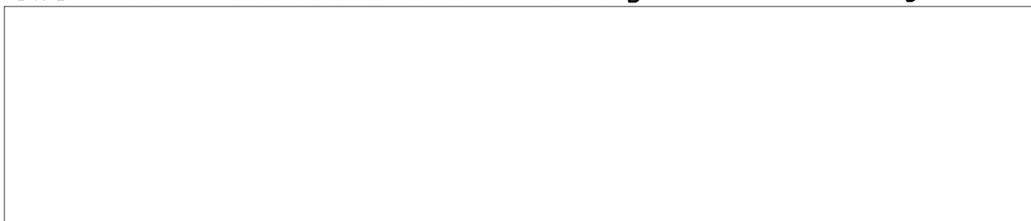
(2) For each class of vehicle each manufacturer in Canada must maintain the Canadian dollar content in those vehicles produced in Canada at least at the 1964 level -- in the aggregate the Canadian dollar content in Canadian vehicles was about \$765 million in 1964.

Furthermore, under part one, individuals may not import cars or parts duty free into Canada; this is in contrast to the freedom US individuals have to import Canadian built cars, although they are unlikely to do so since retail car prices are higher in Canada than in the United States.

In the US view, the restrictions on duty free entry into Canada were designed to protect Canada's industry only during an adjustment period. The United States Government believed the restrictions would be transitional in nature. The Canadian Government, though uneasy about the impasse that has developed in bilateral discussions on the agreement, is now unwilling to drop the transitional measures without compensation. The Canadians have suggested, for example, that the transitional arrangements could be dropped in conjunction with broadening the coverage of the agreement -- for example, to include tires and tubes. Aside from the fact that in the US view the Canadians are already bound to remove the transitional restraints, the problem is to determine how much of the change in our automotive balance is due to these transitional restraints and how much is due to other factors.

The conditions agreed to by the American-owned Canadian vehicle manufacturing subsidiaries in Part two were undertaken with Washington's knowledge.

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The agreement was very generous to the Canadians. Given that Canadian content was guaranteed to grow in line with sales in Canada by one provision of the letters of undertaking, Canada was assured at least as much benefit in terms of production and the automotive bilateral trade balance as it could have received with continuation of the contentious duty rebate program. The further commitment of \$240 million production growth gave Canada a bonus it could not have otherwise expected to achieve.

#### Impact of the Agreement

The United States, contrary to expectations, has suffered a substantial economic loss due to shifts in the distribution of automotive production -- and the trade balance -- engendered by the agreement. Although the size of the production shift and the change in the bilateral automotive trade balance has been a subject of controversy for the last few years, the two governments have now agreed on a common set of trade data.

The overall US automotive trade balance with Canada -- traditionally in surplus -- deteriorated drastically; from a surplus of \$560 million in 1964, the year prior to the agreement, to a deficit of \$315 million in 1970 (see Table IV-1). The

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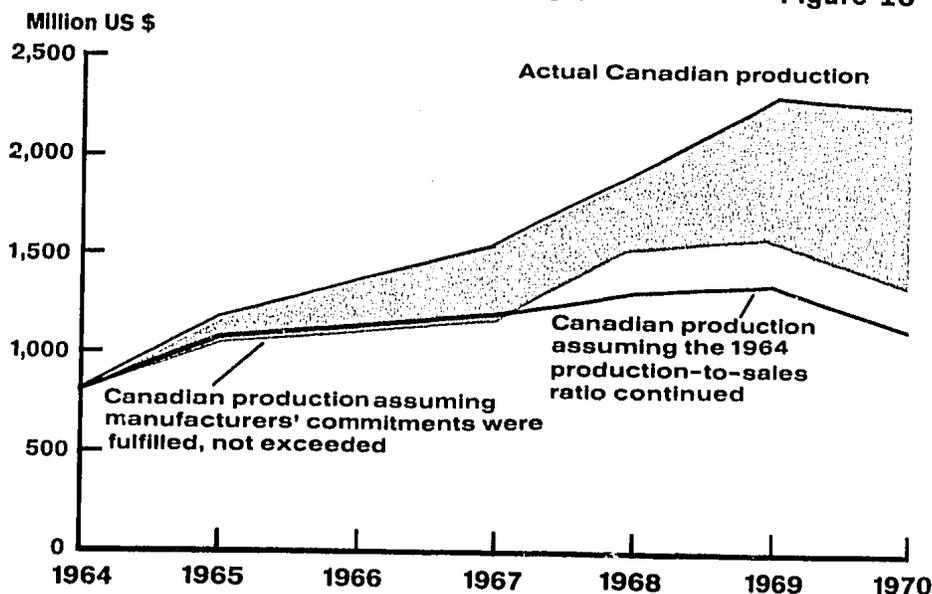
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shift in the US balance since the agreement is due to the change in the US position from that of a small net exporter of completed vehicles and chassis to that of a very large net importer. Although the US role as a net supplier of parts to Canada has increased substantially, the increase has not been large enough to offset the deterioration in the trade balance in assembled vehicles and chassis.

As a consequence of the automotive agreement and the over-fulfillment by the manufacturers of their commitments to the Canadian Government, automotive production that would have taken place in the United States has shifted to Canada (see Figure 16). Although it is difficult to estimate what the case would have been in the absence of an agreement, it is clear that Canadian automotive production has increased more rapidly, and American production has grown less rapidly, than they would

### CANADA: Automotive Production

Figure 16



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have if the system existing prior to the agreement had continued, or if the manufacturers' commitments to the Canadian Government had only been fulfilled, and not exceeded. The value of Canadian automotive production in 1970 is estimated to have been about \$2,300 million, and the value of automotive sales of American-type vehicles in the Canadian market about \$1,870 million. If the ratio of Canadian production to Canadian sales prevailing in 1964 had prevailed in 1970, Canadian automotive production would have been only \$1,150 million -- half the amount actually recorded. Moreover, even with the agreement, if the manufacturers' commitments in the letters of undertaking had been fulfilled, not exceeded, including the supplemental commitment to increase value added by \$240 million, Canadian automotive production in 1970 would have been only about \$1,380 million -- \$920 million less than the recorded amount. To be sure, some portion of the increased Canadian production returned to the United States through higher profits of US automotive subsidiaries in Canada and through increased US exports of ancillary products such as raw and semi-finished materials like rubber and steel, and machinery and equipment used in the production of vehicles and components. Nevertheless, there has been a substantial loss in US production as a consequence of the agreement.

### Why Canada Has Done So Well

The exceptional growth of Canada's automotive industry -- in excess both of US and Canadian expectations -- results from a combination of factors: the impact of the transitional arrangements in the early years of the agreement, growing Canadian efficiency, the allocation to Canada by US auto industry executives of popular models, and continuing Canadian Government pressure to obtain higher Canadian content. Although Canadian practices have played some part in the overfulfillment by the manufacturers of their growth commitments\*

\* *The Canadians have, for example, defined the "factory cost" of imported vehicles so that their apparent value is increased by about 10%: Intra-company transfer prices rather than factory cost are used to value [footnote continued on p. IV-8]*

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the major reason that growth continues to be so rapid, now that the transitional arrangements no longer have any direct effect, is that it has not been particularly costly for US subsidiaries to give in to Canadian pressures.

To comply with the agreement and letters of undertaking, the auto makers substantially increased their investment in Canada. In the first two years of the agreement, the manufacturers invested \$335 million in improved Canadian facilities (see the map, Figure 24); US producers of original equipment parts, at the urging of their automotive customers, also invested heavily in Canada. Because economies of scale are so important in automotive production many of the new facilities had capacities much greater than necessary to fulfill the conditions in the bilateral agreement or the letters of undertaking.

US subsidiaries in Canada, because of their "overinvestment" in new facilities and the slower than expected growth of the Canadian automotive market, have far exceeded the requirements placed upon them by the Canadian Government through the transitional arrangements. Until car sales in Canada increased to the level of Canadian production the producers planned to use the temporarily excess Canadian capacity to produce for export to the United States. This practice also provided a "safety margin" for manufacturers in honoring their undertakings in the event that market forces lowered Canadian production or raised Canadian sales from projected levels. However, sales in Canada of vehicles produced in North America have not grown at all so both excess capacity and Canadian exports have been greater than expected. For new automobile sales in Canada, see the following tabulation:

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*Canadian vehicle imports. Thus a decision to "source" a vehicle sold in Canada from the United States raises the amount of value-added required of the Canadian vehicle producer by approximately this amount.*

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<u>Thousand Units</u>		
<u>Year</u>	<u>American-Type</u>	<u>European/Japanese</u>
1964	551	66
1965	634	75
1966	627	68
1967	605	74
1968	637	104
1969	638	122
1970 <u>a/</u>	497	128

*a. Preliminary.*

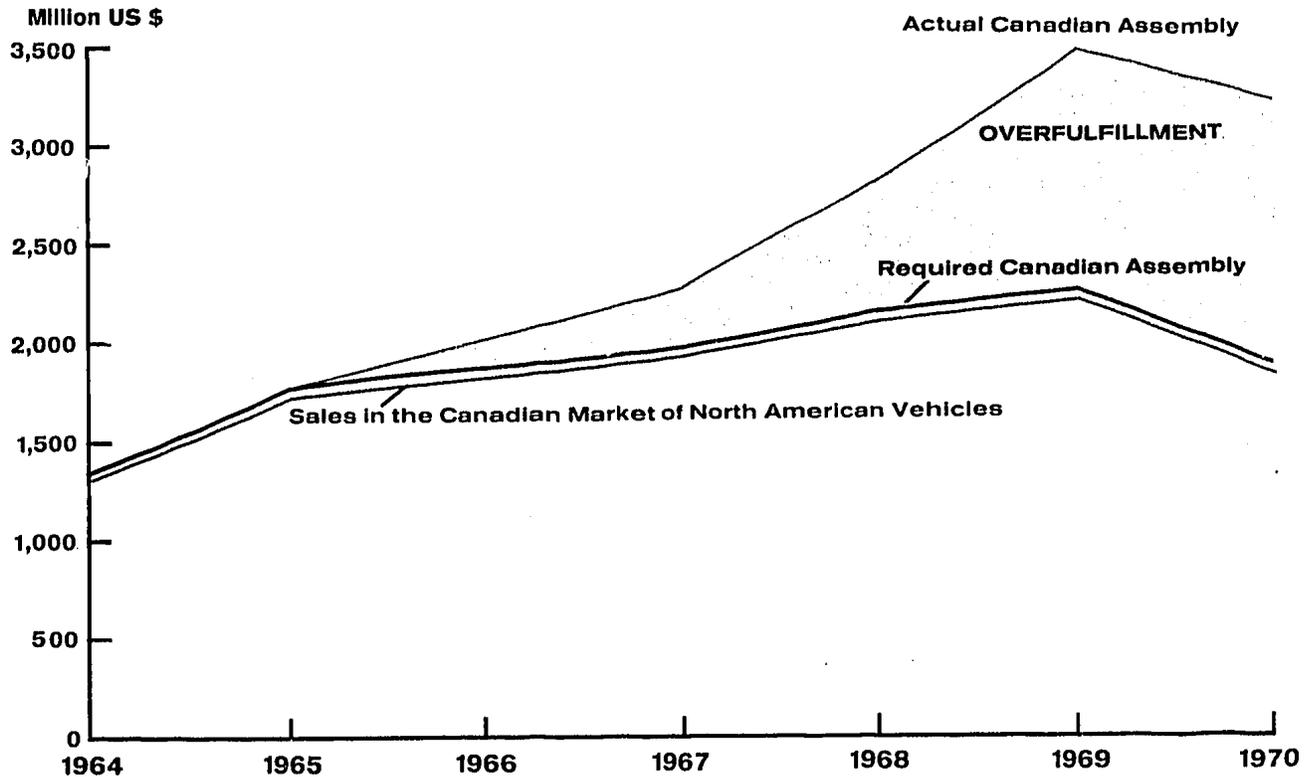
Each manufacturer has consequently maintained the ratio of Canadian assembly to Canadian sales at a level far in excess of the 1964 base; in 1964 the ratio of assembly to sales was about 1.01, in 1970 the ratio had reached 1.72. In other words, in 1970, for every \$100 of their sales in the Canadian market, the manufacturers assembled in Canada vehicles worth \$172 (see Figure 17). The requirement in the agreement that the dollar amount of Canadian content in those vehicles produced in Canada be at least maintained at the level that was obtained in the 1964 model year has also been substantially exceeded. The Canadian content of Canadian vehicles was about \$1,130 million in 1970, 1.5 times the 1964 base.

#### Canadian Costs and Specialization

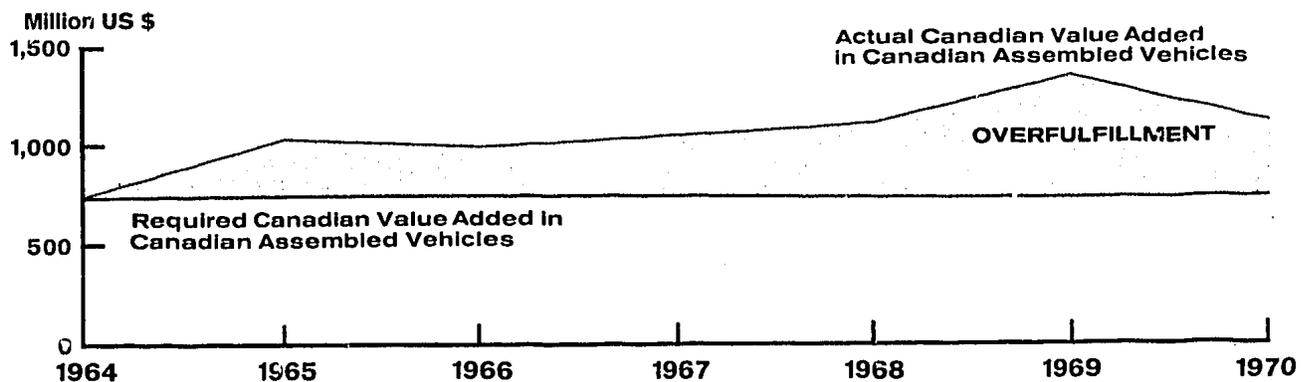
Efficiency in the Canadian segment of the auto industry has increased because of new investment, and because of integration by the vehicle manufacturers of much of their US and Canadian operations. Certain car models are no longer produced in Canada, and Canadian demand for such models is supplied entirely from the United States. For example, General Motors has reduced the number of car models produced in Canada to about one-half the pre-agreement level. In those models in which Canada does specialize, the plants have larger and more efficient production runs.

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**CANADA: Fulfillment of the Transitional Arrangements** Figure 17  
**Canadian Vehicle Assembly and Sales in the Canadian Market**



**Canadian Value Added in Canadian Assembled Vehicles**



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Through specialization and increased trade\* the gap between US and Canadian automotive prices and wages has been narrowed. Automotive prices, which were substantially higher in Canada than in the United States prior to the agreement, are now only about 2% to 8% higher. Canadian workers, who in 1964 received less than three-fourths the wage of their Detroit counterparts, have achieved nominal wage parity. For the same task a Canadian worker is paid the same dollar wage. Because of the shift in the distribution of production, the increase in wages was accompanied by increased employment despite sluggish Canadian demand. Company profits have probably also increased substantially because of increased efficiency, although there are no available accurate measures.

Canadian production costs have probably now been reduced to the US level. Canadian labor productivity is equal to that of the United States. Canadian automotive plants, although smaller, are generally more modern than our own, and Canadian workers in comparable jobs are generally more skilled than US workers. Moreover, prices for steel and other raw materials and for utilities are about 5% lower in Canada than in the United States.

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*\* The phenomenal increase in bilateral automotive trade reflects and underscores the integration of the Canadian and US automotive markets. Back and forth intra-industry traffic in materials, parts, components, and vehicles swells the foreign trade figures of both countries.*

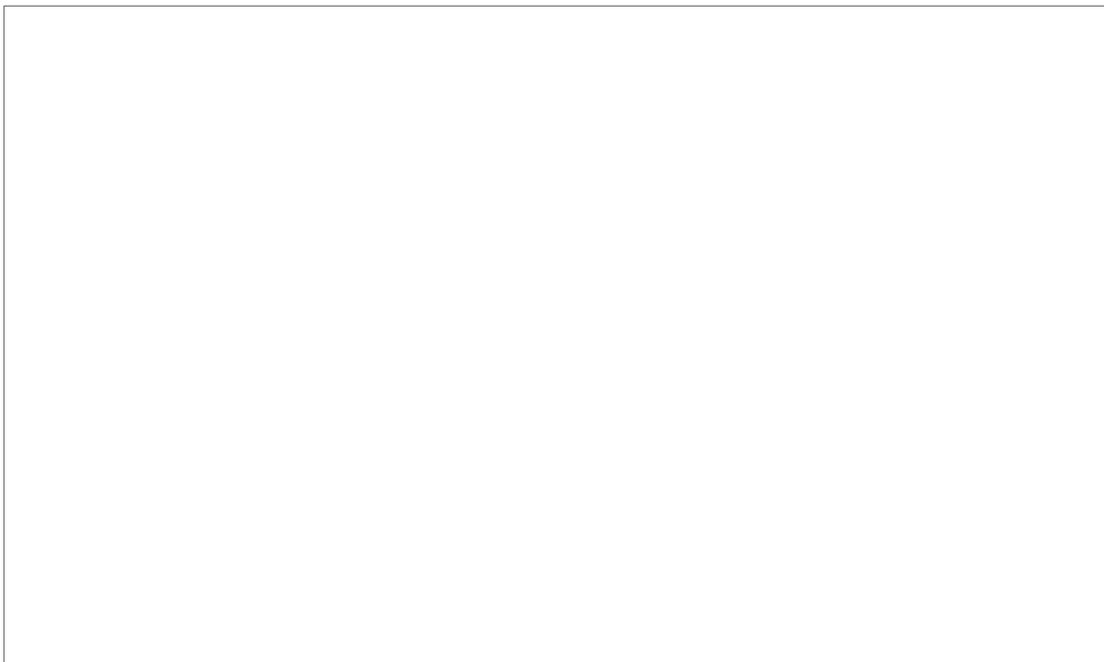
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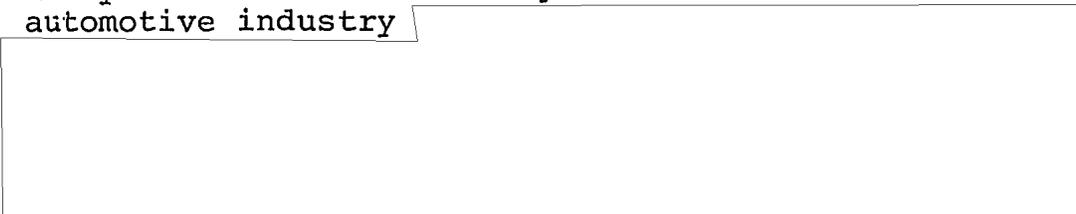
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Prospects

We believe that the distribution of automotive production will probably shift in the United States' favor in 1972 although our overall automotive trade balance with Canada will continue in substantial deficit. This is because Detroit has become increasingly aware of Washington's dissatisfaction with the agreement and with their overfulfillment of the commitments to the Canadian Government. As a result these executives have planned to reduce the level of overfulfillment, and will reduce their parts purchases from independent Canadian suppliers. The 600 or so independent Canadian suppliers have always been the weakest segment of the Canadian automotive industry

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The US automotive trade balance with Canada is likely to stabilize or improve slightly after 1972, but it will continue in deficit until Canadian demand for North American vehicles increases sufficiently to absorb a substantially greater share of Canadian capacity. Even then the trade balance will not shift so strongly in favor of the United States that the balance will be as favorable as it was in the pre-agreement period.

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Table IV-1  
US-Canadian Trade in Automotive Products

	Million US \$						
	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>
US Exports to Canada	<u>533.3</u>	<u>879.9</u>	<u>1,366.6</u>	<u>1,881.0</u>	<u>2,608.0</u>	<u>3,110.3</u>	<u>2,889.7</u>
Passenger cars	33.8	36.5	267.3	543.5	747.9	732.4	632.6
Trucks, buses, and chassis	22.9	55.4	88.4	121.8	175.9	243.7	258.9
Parts and accessories	576.6	738.0	1,010.9	1,215.7	1,684.2	2,134.2	1,998.2
US Imports from Canada	<u>71.0</u>	<u>227.0</u>	<u>811.2</u>	<u>1,394.5</u>	<u>2,266.4</u>	<u>3,089.2</u>	<u>3,204.7</u>
Passenger cars	17.9	68.5	316.0	692.1	1,114.2	1,550.3	1,514.2
Trucks, buses, and chassis	3.8	19.3	135.0	228.3	369.2	580.0	610.9
Parts and accessories	49.3	139.2	360.2	474.1	783.0	958.9	1,079.6
<i>Net US exports</i>	<i>562.3</i>	<i>652.9</i>	<i>555.4</i>	<i>486.5</i>	<i>341.6</i>	<i>21.1</i>	<i>-315.0</i>

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## APPENDIX V

Manufacturing and AgricultureIntroduction

The present composition of Canada's economy began to take shape between 1896 to 1913. Producing wheat for export stimulated new and diverse activity throughout the country. This period was Canada's first great economic boom. Because of wheat, railroads were built, and because railroads were built, mineral exploitation was made possible. During the same years the expanding US demand for newsprint began to be met by Canada's forests; its waterfalls generated the hydroelectric power to turn the woodpulp into paper. Again this period, which saw the increasing urbanization of the United States, also saw the movement of American tourists in ever increasing numbers into Canada. Wheat, paper, minerals, and tourism continue today to produce most of Canada's foreign exchange and provide the stimulus to the rest of its economy.

Manufacturing and agriculture now account for almost 40% of GNP (see Figure 18). The manufacturing industries are the largest sector of the economy after services and account for approximately 33% of both jobs and income. Manufacturing's share of corporate profits is approximately 60%, and employees in manufacturing earn about 40% of total wages and salaries. Agriculture accounts for about 6% of GNP and about 7% of the labor force. Agriculture accounts for 10% of exports and manufacturing for 58%.

ManufacturingDiscussion

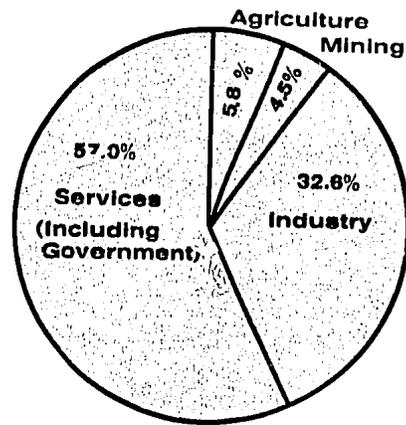
There had been slow but steady progress in manufacturing since the National Policy of the 1870s that gave Canadian industry a tax shelter under which to grow. The process that was started in the boom period of 1896-1913 had scarcely begun to decelerate when it picked up again under the stimulus of World War I. The production of copper, zinc, and nickel, needed for ammunition and armor plate, almost doubled in value between 1914 and 1918. The Canadian aircraft industry began in 1917, followed by the growth

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### CANADA: Structure of the Economy, 1970

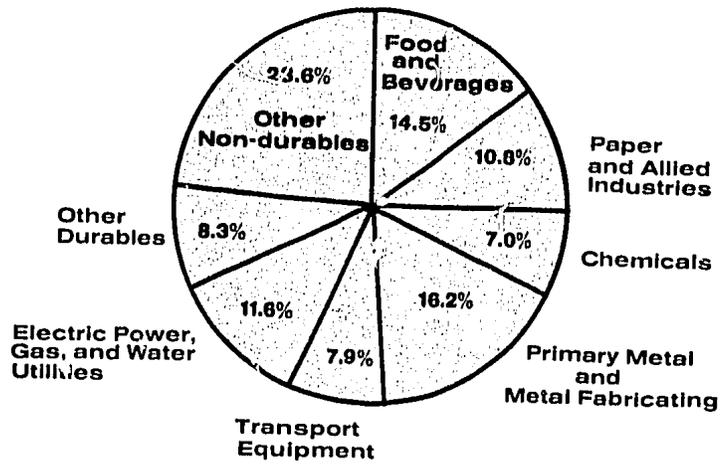
Figure 18

Structure of the Economy



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Structure of Industry



of the aluminum refining industry in later years. At the end of World War II, Canada had matured as a manufacturing nation.

Manufacturing has continued to grow steadily, stimulated by a rise in domestic demand and by the development of export markets -- especially in the United States. Manufacturing output increased between 1947 and 1970 at an annual rate of about 5%. Capital stock in manufacturing increased at about the same rate, while employment increased about 2% annually. Growth rates varied considerably within the manufacturing sector. Clothing, rubber, and the leather products industries grew less than 3% annually while petroleum products, electrical products, and the miscellaneous group of manufacturing products, including scientific and precision equipment and recreational products, grew at 8% or more. Chemicals and nonmetallic mineral products also experienced high rates of growth as did machinery manufacture, textiles, and knit goods.

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Manufacturing activity is heavily concentrated in Ontario and Quebec (see the map, Figure 24). Ontario accounts for 52% of all manufactured output and has the most diversified production. Automobiles and primary steel are its leading industries, followed by prepared foods, distilled liquors, chemicals, electrical and electronic apparatus, rubber goods, and industrial, agricultural, and business machinery. Quebec -- accounting for 28% of total manufacturing output -- has as its largest industries metal smelting and refining, and pulp and paper. It is also the leading producer of cotton and synthetic textiles, clothing, tobacco products, shoes, and aircraft.

Elsewhere, manufacturing has developed primarily to serve regional needs or to exploit regional resources. British Columbia produces more than half the total output in the wood group. In the Prairie provinces, the leading industries are slaughtering and meatpacking, dairying, petroleum refining, and flour milling. The production in this area of pipe and other steel mill products, compressed gas, plastics, industrial chemicals, and fertilizers is a consequence of the local growth of petroleum and natural gas production. In the Maritime provinces, the leading industries are pulp and paper, primary steel, and fish processing, with these four provinces producing more than half of Canada's processed fish output.

Government Policy

To assist industry in increasing output and improving efficiency and to help develop depressed areas, the Canadian federal and provincial governments have developed extensive programs. Defense production is assisted by special grants, loans are provided under a program to advance industrial technology, and -- under the Regional Developments Incentives Act -- grants are made to establish industries in areas of chronic unemployment and slow economic growth.

Ottawa recognizes that Canada's relatively high tariffs (see Figure 7), which have been maintained for many years, have resulted in a  manufacturing sector that has difficulty competing in international markets. Except in the export-oriented resource industries and the automobile

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industry, manufacturers are often under the handicap of producing a wide variety of goods for a domestic market only 8% as large as the US market. Most firms are unable to take advantage of the economies of scale so important in manufacturing and serve the small Canadian market at high cost.

To remove the handicap of short and inefficient production runs, Ottawa is seeking to "rationalize" its industries. Rather than continue to produce a wide variety of goods for the relatively small domestic market, Ottawa is seeking to have industries specialize in a more limited product line both for the domestic market and for export -- primarily to the United States -- while importing those manufactures not produced in Canada. An export promotion effort has consequently been undertaken for manufactured goods. Some of the export promotion techniques, however, [redacted]

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[redacted] conflict with US interests and regulations.

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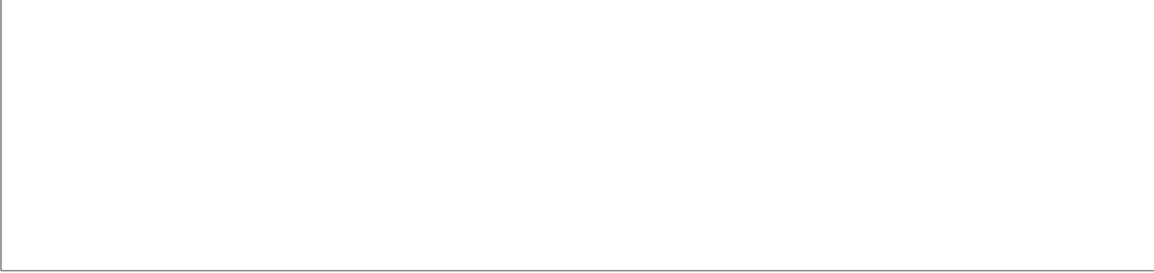
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The Electronics Industry

The computer industry provides an example of Canadian Government pressures for increased production of manufactures in Canada. As far back as 1968 the Canadian Government engaged in an extensive study of the computer industry with an eye to eliminating Canada's substantial trade deficit for that commodity.\* Following the study, the government intimated to the major US firms exporting to Canada that, unless they began subcontracting work and establishing plants in Canada, restrictive measures to correct the trade imbalance would be considered. These included setting up a national computer industry similar to the French industry, where private companies have been forced to form a company in partnership with the government. Ottawa hoped to convince the companies to spend in Canada on computer research the same proportion of their Canadian sales as their parent companies expended worldwide on research in relation to their total sales. The government also wanted the computer companies to manufacture computer equipment in Canada at least equal in value to the total of their Canadian computer sales.

Most of the major American computer manufacturers capitulated to Ottawa's demands, with IBM, Honeywell, and Sperry Rand announcing plans over the past two years to establish new Canadian plants; more recently Control Data Corporation (CDC) announced a \$56 million investment to take place during 1971-76. Of this amount, the Canadian Government gave CDC a \$23 million grant to build the facilities.

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\* *The size of the bilateral trade deficit in computer products is about \$116 million.*

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The Canadians in 1968 also stated that they would like an agreement with the United States on computers similar to the auto agreement so that entire specialized segments of the North American industry would be located in Canada and be capable of exporting to the United States. The 1965 US-Canadian Automotive Products Agreement established duty free trade between Canada and the United States in automotive products, subject to certain production guarantees given to Canada. The agreement, by eliminating US and Canadian tariffs, facilitated rationalization and specialization; consequently Canadian production costs were reduced to the US level. An agreement for the computer industry that similarly provides for duty free trade in computer products would permit the computer companies to specialize more easily in certain product lines in Canada, increase their efficiency, and increase their Canadian production at lower cost.

US Interests

US direct investment in Canada is extensive; the book value reached \$21 billion in 1969, or 30% of the worldwide value of US investment.\* The magnitude of US capital in Canada makes the companies particularly sensitive to manifestations of Canadian nationalism and to government pressures. The cost to the companies of complying with Canadian demands for specializing in certain product lines is generally small. In turn, Canada obtains the benefits of mass production by exporting to the United States while importing other lines from the United States to sell in the domestic market. US industrial tariffs are generally low, and Canada often permits duty free import where it facilitates specialization. Unless counter pressures are generated by the US Government, the expedient thing for the companies to do often will be to give in to Canadian pressure.

That the Canadians will continue to exert pressure on US firms to rationalize and increase their production in Canada seems likely. The Canadians

\* For a discussion of the role and importance of US investment in Canada, see Appendix VI, "US Investment in Canada."

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are content with the trade surpluses in the mineral sector, but in any sector in which they have a deficit they say they desire balanced trade and argue that they do not have their "fair share" of production. The US-Canada Defense Production and Development Sharing Program (DPSP) is a result of Canadian demands for their "fair share" of defense output. The DPSP is supposed "to assure the maintenance of a long-term balance, at the highest possible level, in reciprocal procurement of items of mutual defense interest...." Since 1959, however, Canada has purchased only \$1.9 billion of defense equipment from the United States, while the United States has purchased \$2.4 billion worth from Canada. In recent years that imbalance has been increasing by more than \$100 million per year.

AgricultureDiscussion

Canada's traditionally favorable agricultural trade position has been eroding in the last two years. This shift in Canada's trade position highlights the problem confronting Canadian agriculture. Farming is concentrated in production of grains, and a restructuring of crop patterns is urgently needed to eliminate the large stockpiles of grains now held and to provide the products demanded by the Canadian and international consumer.

Canadian farming has made significant progress in increasing output and improving efficiency. Improved techniques and the use of modern machinery, fertilizers, and improved seeds have greatly increased agricultural productivity. During the past 20 years output has increased about 20%, the agricultural labor force has declined by about two-fifths, and the number of farms has been reduced by about one-quarter. Machine power has increasingly replaced man and animal power, techniques of harvesting have strikingly altered, and the upsurge of rural electrification has brought the amenities of the farm household closer to urban standards.

The type of farming practiced varies considerably in Canada from region to region (see the map, Figure 24). In the Atlantic region the most important types

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of commercial farms are dairy, cattle, hog, and sheep and farms specializing in field crops other than small grains. In Quebec, nearly two-thirds of the commercial farms engage in dairying, and they account for about one-half of all dairy farms in Canada. In Ontario the predominant type of farm is cattle, hog, and sheep (40%) followed by dairy farms (30%). In the Prairie region, about 45% of farms are classified as wheat and a further 16% specialize in small grains. In British Columbia, dairy farms constitute 27% of all farms, followed by fruits and vegetables (23%) and cattle, hogs, and sheep (20%). For Canada as a whole, the largest number of farms produce cattle, hogs, and sheep, followed by dairy farms and wheat farms. Cattle, hog, and sheep farms also provide the greatest share of sales of agricultural products by commercial farms, followed by dairy and wheat farms.

### Trade

Ranking sixth among the world's trading nations, Canada's economy depends on the maintenance of a high level of trade. Although Canadian agricultural exports have declined in recent years, they continue to be a significant source of export earnings. Wheat and wheat flour have consistently dominated agricultural exports, accounting for 43% to 65% of the total since 1959. Canada is the second largest wheat exporter after the United States.\* None of the other important agricultural exports accounted for as much as 5% of total agricultural exports even in 1969, a particularly poor year for wheat.

Although the United States and the United Kingdom are the principal markets for Canadian agricultural exports, their combined share of total Canadian agricultural exports in the period 1959-68 dropped from 54% to 40%. Most of the decline is attributable to the drop in sales to the United Kingdom. Other important markets are Japan (12%), Mainland China (11%), the European Community (11%), and Eastern Europe and the USSR (9%).

\* For a discussion of Canada's wheat exports to the Communist countries, see Appendix I, "Canada's Foreign Trade."

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Major Canadian imports are fruits and vegetables, followed by meat and fish, cotton, corn, and specialty products such as coffee, cocoa, tea, and alcoholic beverages. Fruits and vegetables alone account for about 45% of agricultural imports. The United States supplies more than half of these imports. The bulk of the remainder comes from South America, the United Kingdom, and Australia and New Zealand.

Government Policies

Government agricultural policy is designed to assure adequate farm income, support a high rate of economic growth, and provide sufficient farm products for both domestic and foreign markets. Official policies include import protection and export assistance (including subsidies and insurance programs), subsidies on farm inputs and transportation, and stabilization of farm prices through price supports. The federal and provincial governments have also fostered the creation of a large number of commodity marketing boards. The Canadian Wheat Board, for example, functions as a monopoly in commercial marketing for grain producers. In addition to pricing, the Wheat Board buys, stores, and sells grains.

In March 1970 the Canadian Government instituted a program called Lower Inventories for Tomorrow (LIFT), designed to reduce burdensome stocks of wheat. Subsidies were provided for diverting wheat area to forage and summer fallow. A combination of payments for not producing and unfavorable weather at planting resulted in a reduction of about one-half from the previous year's wheat acreage. Some aspects of the LIFT program are being carried over into 1971 with the intention of converting up to 4 million acres of land presently in crops to grassland within the next three years. Other recent developments have included a more flexible policy in determining Prairie grain delivery quotas and a new Canada Grain Act that permits a changeover from the traditional grading system to new wheat grades, fewer in number and stressing protein content. The government hopes that this system will more adequately meet foreign demand.

The government also plans to initiate in August 1971 a Prairie Grains Policy program containing

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guaranteed income provisions. As presently constituted, the plan will guarantee grain farmers total cash receipts each year equal to their previous five-year average. Crops to be covered are wheat, barley, oats, rapeseed, flax, and rye. Payments will be made in any year that total cash farm receipts from the named crops fall under the previous five-year average. The program works much like insurance, with farmers paying part of the costs from delivery receipts in good years and receiving payments in bad years; the government will supply the balance.

US Interests

The United States customarily supplies about 50% of Canada's agricultural imports, making Canada our second best customer for agricultural exports after Japan. The United States also takes about one-fourth of Canada's farm exports, making the United States Canada's most important market.

In the 1959-68 period, US agricultural imports from Canada -- almost all of which are supplementary to US agricultural production -- totaled over \$200 million annually. The principal imports were live animals, and meats and meat preparations -- accounting for over 41% of total agricultural imports from Canada in 1968. Other important imports included animal feeds, semi-processed drugs, bakery goods, apples, barley, grass and clover seeds, and maple products. Since 1959, imports of beef and veal, fruits, nuts, bakery goods, crude drugs, and mustard seeds have increased greatly\*, but imports of wheat, barley, and malt have declined significantly.

In recent years, US agricultural exports to Canada have averaged close to \$500 million, more than twice the value of our agricultural imports from Canada. About one-quarter of these exports is complementary to Canadian agricultural production. Fruits and nuts, vegetables, soybeans, corn, and meat accounted for almost 70% of the total value of US agricultural exports to Canada in 1968.

\* *For a discussion of the factors accounting for the sharp increase in US meat imports from Canada, see Appendix I, "Canada's Foreign Trade."*

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**CONFIDENTIAL**Bilateral Issues

The trend in Canadian agricultural trade policy has been toward solving domestic problems at the expense of traditional imports from the United States. This may be simply a drift toward the politically easy way out rather than a conscious change in policy, but, over the past two years, the United States has been confronted with a number of new or potential trade restrictions. For example, the Canadians have proposed an increase in their duty on live turkeys, have begun to subsidize dehydrated alfalfa plants, and several provincial marketing boards have imposed discriminatory restrictions on imported poultry products. Recently the Canadians have asked to renegotiate their tariff concessions on certain agricultural products. The Canadians also proposed to create a new national marketing agency with the power to discriminate against imports, which could further impair US agricultural interests. The Canadian Minister of Agriculture, in discussing the new marketing agency, came close to suggesting that imports would be permitted only when all domestic production had been marketed.

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## APPENDIX VI

US Investment in CanadaIntroduction

Foreign investment plays a greater role in Canada than it does in any other industrial nation. Foreign direct investment as a percent of GNP is 12 times larger in Canada than in the United States (see Figure 2). Over 50% of Canadian corporations with assets greater than \$25 million are foreign-owned -- primarily by US companies. Most Canadians are aware of the economic benefits that have resulted from foreign investment. They are concerned, however, about the implications of foreign control for Canada's national independence and economic growth.

Discussion

The United States has been Canada's principal source of foreign investment since 1922. While British capital financed the building of Canada's large rail network in the nineteenth and early twentieth centuries, American capital has financed Canada's rapid growth as an industrial nation since World War I. US investment is 80% of total foreign investment in Canada; the United Kingdom has invested 12%, with all other countries supplying about 8% (see Figure 19).

Canada is a vast country, rich in minerals, but it is sparsely populated and incapable of financing domestically the infrastructure required for continued growth and development. Foreign investment has made exploiting Canada's natural resources possible, and has added significantly to the country's production, employment, and income. At the same time it has added substantially to Canada's external debt burden and intensified the problem of non-resident control of the economy.

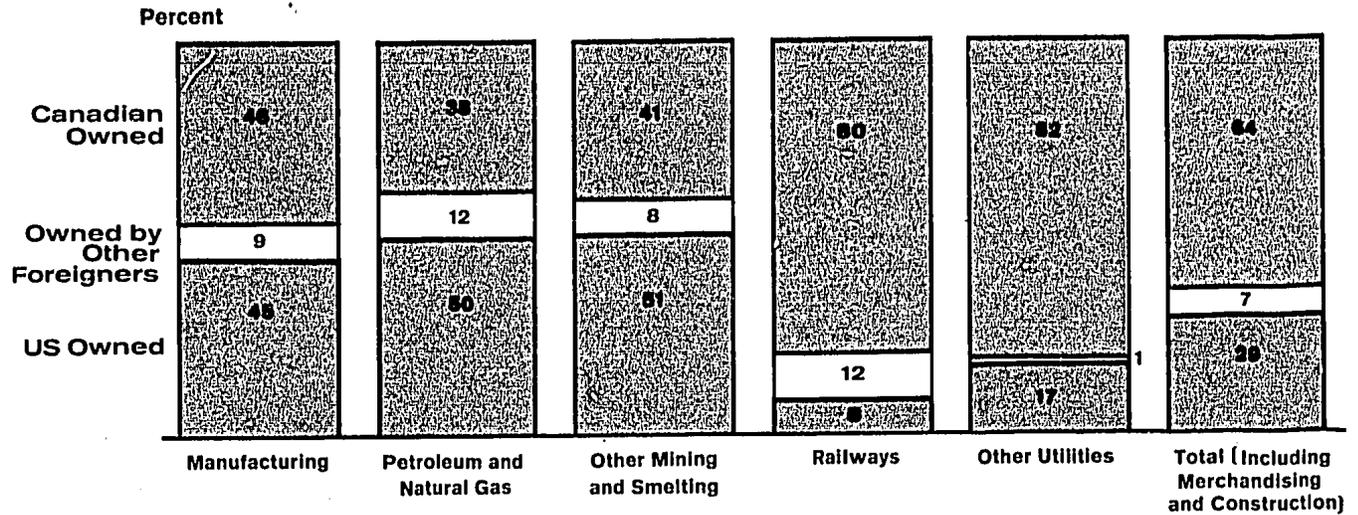
Foreigners now own about \$45 billion in Canadian assets, while Canadians own about \$19 billion in assets abroad. Canada's net indebtedness -- \$26 billion -- has increased markedly from a postwar low of \$4 billion in 1949. Direct foreign investment

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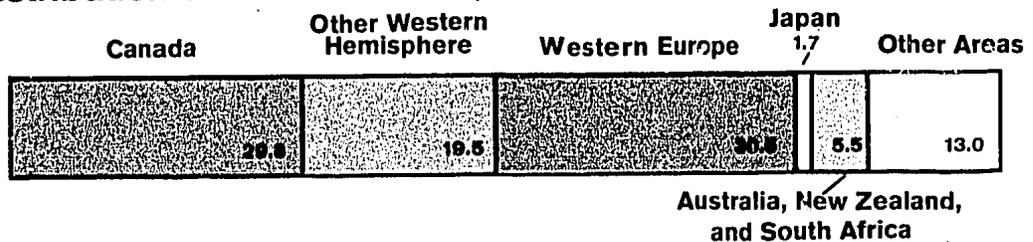
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**CANADA: Ownership of Capital**

**Figure 19**



**Distribution of US Investment, 1969**



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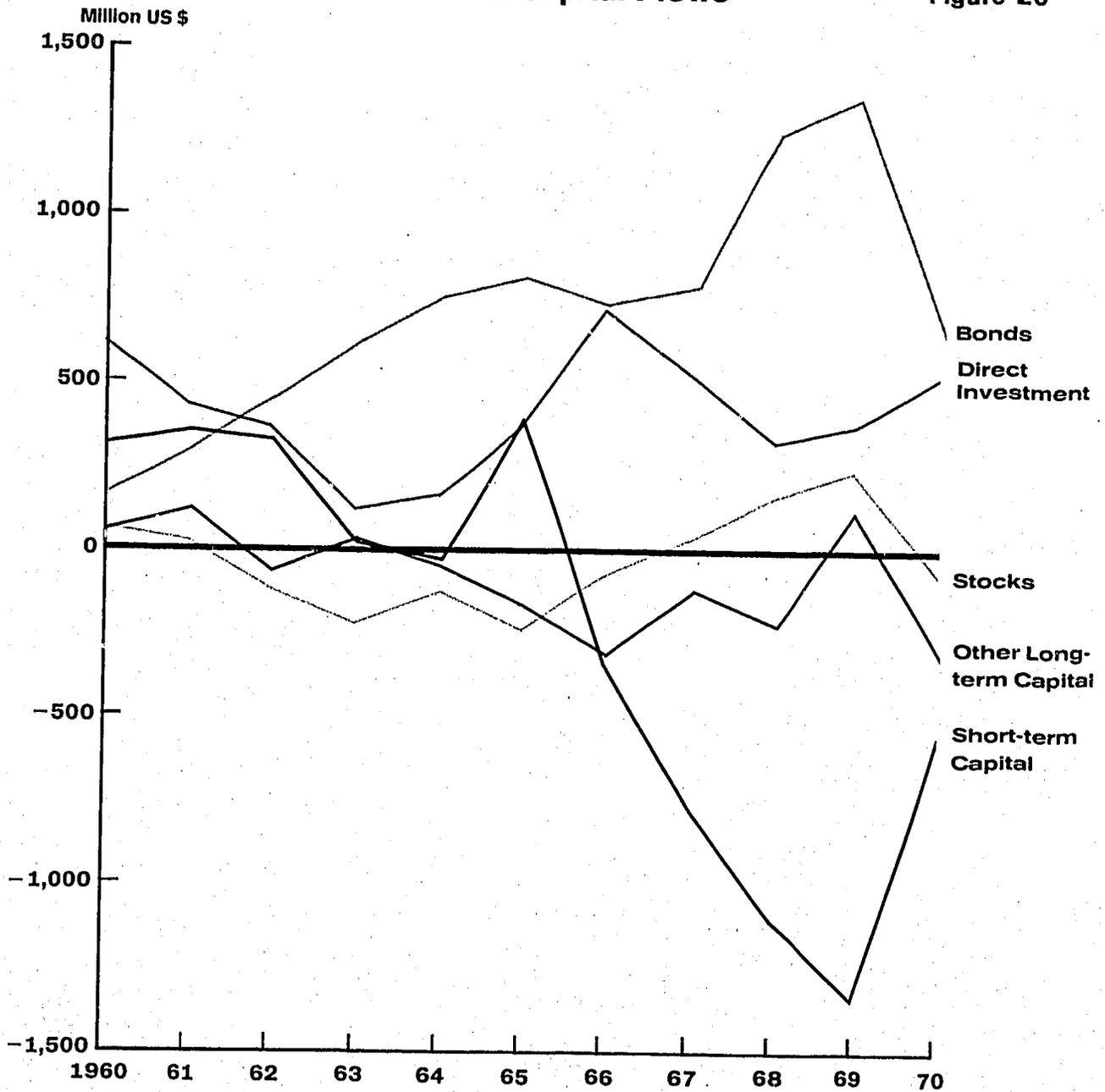
and portfolio transactions account for most of the increase. In 1970, Canada benefited from a long-term net capital inflow of about \$800 million -- primarily from the United States, direct investment accounting for about 65% of the total (see Figure 20).

As a result of increased direct and portfolio investment, payments of interest and dividends to foreigners (exclusive of undistributed profits) were almost \$2 billion in 1970 -- 2½ times more than the inflow of new capital. Interest and dividend payments

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### CANADA and the WORLD: Net Capital Flows

Figure 20



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were both in excess of \$700 million, while payments on short-term and miscellaneous investments made up the rest. Although such payments to foreigners have been increasing in absolute terms, they have been declining as a percent of GNP.

Foreign ownership and control is concentrated in resource industries and in manufacturing. All branches of the petroleum and natural gas industry; iron ore, nickel, and potash mining; and the aluminum and pulp and paper industries are dominated by foreign capital. Foreign ownership also predominates in manufacturing, particularly automobiles and spare parts.

Canadian ownership and control predominate in banking, merchandising, agriculture, housing, public utilities, and transportation. Industries in which the largest part of production is Canadian-controlled include iron and steel, sawmills, feed manufacturing, clothing, and elements of the food and beverage group.

In 1966, US citizens controlled 45% of the assets in Canadian manufacturing, 50% in the oil and gas industries, and 51% in mining and smelting. US investment represented 80% of all non-resident investment in Canada and 30% of US worldwide direct investment. Within the manufacturing sector US citizens control about 92% of the capital employed in manufacturing automobiles and parts, 87% in the rubber industry, 42% in the chemical industry, and 51% in the electrical apparatus industry. The largest US investments in Canada include:

<u>Company</u>	<u>Sector</u>	<u>Owned</u>
General Motors of Canada, Ltd.	Automotive	100% General Motors Corp.
Ford Motor Co. of Canada, Ltd.	Automotive	74.8% Ford Motor Co.
Chrysler Canada, Ltd.	Automotive	100% Chrysler Corp.
Canadian General Electric Co. Ltd.	Electrical apparatus	91.9% General Electric Co.
Dupont of Canada, Ltd.	Chemicals	81.6% E.I. duPont de Nemours and Co.
Imperial Oil, Ltd.	Petroleum	70% Standard Oil Co. (N.J.)
British-American Oil Co. Ltd.	Petroleum	60.9% Gulf Oil Corp.
Texaco Canada, Ltd.	Petroleum	68% Texaco, Inc.

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**CONFIDENTIAL**Benefits to the United States ...

The massive flow of US capital to Canada has generated a reverse flow of interest, dividend, and miscellaneous income payments. In 1970 these payments totaled almost \$1.75 billion (including undistributed profits). The return on direct investment alone was over \$900 million (see Figure 19) -- equivalent to 15.4% of the return on US direct investment worldwide. The interest and dividend flow has been growing at an average annual rate of 10% a year -- slightly more rapidly than the growth rate in US worldwide receipts.

The rate of return on US direct investment in Canada -- only about 7% -- is lower than in other areas of the world but investment still remains attractive. Canadian investments are especially secure and US investment in Canada requires comparatively little home office support. The average rate of return on US direct investment in the less developed countries is almost 19%, in Australia, New Zealand, and South Africa about 10%, and in Europe almost 9%. Much of US investment is concentrated in mining where capital output ratios are high and risks are low thus yielding low rates of return. Locating in Canada is sometimes also the only way to avoid Canada's high tariff barriers and protect an established market position.

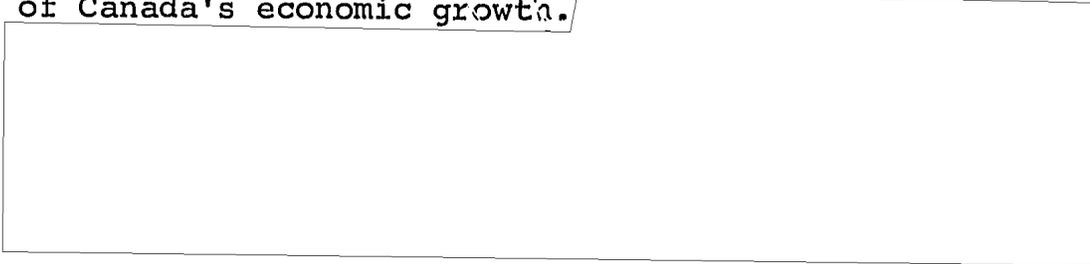
Aside from investment income, the United States benefits from its investment in Canada in a number of other ways. US subsidiaries generally import more from the United States than do similar Canadian-owned firms, thereby increasing US exports. US subsidiaries also appear to rely more on US firms for research and development, further improving our balance on services. Moreover, US investments in the extractive industries increase the availability of certain important minerals, reduce mineral prices, and increase the level of secure productive capacity. These benefits, however, are not derived without offsetting costs. Investment in the United States is possibly reduced somewhat in order to finance the capital outflow.

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... and Benefits to Canada

Foreigners supply the capital, entrepreneurship, technology, and market access that has made possible a much higher level of investment than Canadian savings would support and is responsible for much of Canada's economic growth. ILLEGIB



The export performance of US firms in Canada is also substantially better than that of Canadian-owned companies. Exports of American subsidiaries as a share of Canadian exports have been proportionately greater than the share of American-owned capital possibly because of better market contacts, organization, and experience. Moreover, the sales of US subsidiaries in Canada often displace imports previously secured from the US parent. Although US subsidiaries import more intermediate goods and secure more services from the United States, on the average, than do Canadian-owned firms, they also export more and have greater success in reducing Canadian imports of final goods from the United States than do firms with Canadian resident ownership.



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Prospects for US Investment

Canadian demand for US investment will continue to be strong, as will US corporate interest in Canada. Canadian efforts to solve the unemployment problem will necessitate continuing investment in manufacturing. US demand for Canadian raw materials and energy resources will lead to increased US investment in these sectors. Two major hydroelectric projects -- one at James Bay in Quebec costing \$6 billion and one in Nova Scotia at Fundy Bay costing \$2 billion -- and a gaseous diffusion plant in Newfoundland at Lake Melville expected to require \$1 billion have been proposed. Canada cannot generate the funds required without turning to the United States. The United States, in addition to providing the needed capital, will also be expected in many of the projects to take the bulk of their output.

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## APPENDIX VII

Canadian Financial MarketsIntroduction

The close interdependence of Canadian and US financial markets -- Canadians normally borrowing long-term funds while placing short-term money in the US market -- has proved generally beneficial to both countries. US business has an opportunity to earn profits, dividends, and interest while Canadians have access to the capital they require to develop their country. In light of Canada's dependence on US financial markets, the United States has granted Canada preferential treatment under the Interest Equalization Tax (IET) and the Foreign Direct Investment Regulations. Canadian officials, however, reflecting concern that Canada might lose its financial identity, have placed severe restrictions on the entry of US private financial institutions into Canada. Nevertheless, close financial cooperation between the two countries is likely to continue relatively unimpaired.

Discussion

It was only in the course of the twentieth century that Canada's major financial centers and institutions came into existence. At present, Canada has two important financial centers, Montreal and Toronto. Ottawa is the seat of the central bank, the Bank of Canada, founded less than four decades ago in 1935.

While Canadian banking practices more closely reflect the British system than the American, the Bank of Canada performs basically the same functions as our Federal Reserve System. In addition to acting as the bank of issue, the Bank of Canada regulates the volume of currency and credit through changes in the discount rate, through open market sales or purchases of government securities, and through stipulation of cash reserve requirements for the nation's 10 chartered, commercial banks that operate approximately 6,000 offices throughout the country.

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Canada's 10 chartered banks -- so called because Parliament grants them charters -- are the general bankers of the business community. They specialize in short-term loans and dominate the market for agricultural and trade credit, industrial working capital, and personal finance. Five chartered banks -- the Bank of Montreal, the Bank of Nova Scotia, the Canadian Imperial Bank of Commerce, the Royal Bank of Canada, and the Toronto-Dominion Bank -- have national branch systems and, except for the last, all have numerous overseas branches. The remaining five chartered banks generally confine their operations to only one province. Four of these, *Banque Canadienne Nationale*, *Banque Provinciale du Canada*, the Mercantile Bank of Canada, and *Banque Populaire* (chartered in late 1969), are headquartered in Montreal. On 31 December 1970 the 10 chartered banks had assets of US \$32.4 billion, equivalent to approximately 60% of the total assets of New York's two largest banks, First National City and Chase Manhattan.

Complementing the chartered banks are the many other elements within the financial framework that provide Canada with relatively well developed, although small, money and capital markets. Trust and mortgage loan companies, sales finance and consumer loan companies, credit unions, life insurance companies, and stock markets all supplement activities of the commercial banking sector. Canada has three major stock exchanges and a number of smaller ones. The Toronto Stock Exchange is the largest, with volume exceeding that of the two other major exchanges (the Montreal Stock Exchange and the Canadian Stock Exchange, both located in Montreal). Combined transactions on all three exchanges, however, are dwarfed by those on the New York Stock Exchange. The average monthly value of shares traded on the three major Canadian exchanges in 1969 and 1970 was \$616 million and \$405 million, respectively, compared with \$10,800 million and \$8,590 million for the New York Stock Exchange in the same years.

Canadian Dependence on US Financial Markets

Although the two major Canadian financial centers are expanding, the Canadian financial

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structure does not adequately meet the needs of the nation. If Canada did not have easy access to Wall Street, it would have to seek funds elsewhere since its economy is incapable of generating savings large enough to meet the needs of business and government. Proximity to New York's financial markets, however, has led to substantial Canadian dependence on the United States as a source of investment capital. During the last decade, Canadian public and private bond issues averaged more than US \$5.8 billion annually with bond placements exceeding US \$8 billion in both 1968 and 1969 (see Table VII-1). Foreign markets accounted for about 17% of total bond subscriptions during the 1960s, virtually all of which came from the United States (see Table VII-2). Indeed, both official and private Canadian borrowing in the United States have been substantial. In 1968 and 1969, however, Canadian borrowers turned increasingly to Eurocurrency and other foreign capital markets where interest rates were lower than in the United States. Nevertheless, Canadian demands on the US markets remained strong. In 1970, Canadians began to return to the US market as the rate structure reversed.

**Special US Concessions for Canada**

The Interest Equalization Tax, imposed in July 1963 as a US balance-of-payments measure, was designed to reduce foreign borrowing in US securities markets by taxing US investors who purchase foreign issues offered in US markets in an amount roughly equal to the difference between the lower domestic and higher foreign interest rates. Canadians quickly expressed alarm at their possible exclusion from US capital markets. This concern led to an agreement giving new Canadian issues tax free access to US financial markets providing the Bank of Canada imposed a ceiling on total official Canadian reserves at US \$2.55 billion. The effect of the ceiling was to reduce the amount of funds Canadians could borrow abroad that would increase reserves even temporarily. This ceiling, however, was subsequently lifted in late 1968 on the understanding that Canadians would limit "unnecessary" borrowing in the United States that would increase reserves permanently.

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While Canada's reserves remained relatively stable in 1969, they rose sharply in 1970, rising by \$1.6 billion to reach \$4.7 billion by year's end. This increase in reserves can be fully accounted for by an improvement in the current account balance -- merchandise trade yielded a \$3 billion surplus, nearly half of which was with the United States. The total net long-term capital inflow in 1970 was \$1.3 billion less than the previous year.

The problem was, from the US point of view, that Canada's large balance-of-payments surplus occurred at the same time that the spread in interest rates between the United States and Europe widened substantially. Rather than deposit their short-term funds here, many Canadian institutions opted to place funds in the Eurodollar market. This had an unwanted effect of increasing US dollar liabilities in Europe at a time when European central banks were complaining bitterly about the rapid increase in their dollar holdings. In this situation, any Canadian borrowing in the United States was indirectly a source of the dollars the Canadians were lending in Europe, although the extent of private borrowing fell in 1970. Preliminary data for the first quarter of 1971 suggest that Canada is continuing to serve as a conduit for US dollars reaching the Eurodollar market, despite Ottawa's efforts to stanch the outflow. The volume of such flows may have approached \$400 million in these three months, and it is highly likely that they are still continuing.

Canada relies heavily on the United States as a source of direct investment. Overall, US direct investment accounts for about 80% of all foreign direct investment in Canada. Indeed it was this dependence that was instrumental in securing complete exemption for Canada from the US Foreign Direct Investment Regulations soon after they were announced on 1 January 1968. These regulations are designed to assist the US balance of payments by imposing annual limits and other restrictions on US direct investment abroad.

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**CONFIDENTIAL**Manifestation of Economic Nationalism

The United States has established a strong economic presence in Canada. While most Canadians realize that US direct investment in Canada is necessary if Canadians are to enjoy a standard of living comparable to that achieved by the United States, American encroachment into the Canadian financial sector -- an area considered of vital interest to the Canadians -- has met with strong resistance. The first major occurrence in the financial sphere that resulted in strained US-Canadian relations was the complete takeover of the Mercantile Bank (Toronto) in 1963 by International Banking Corporation, a holding company of First National City Bank (FNCB), New York. Heated debate regarding action to be taken in response to this first and only foray of an American bank into ownership of an existing Canadian bank culminated in the passage of the 1967 Canadian Bank Act, which *inter alia* restricts foreign ownership of Canadian banks, and limits the deposit liabilities of the Mercantile Bank to 20 times its authorized capitalization of Canadian \$10 billion.\* In 1969, similar legislation placed restrictions on foreign ownership of federally chartered trust, loan, and insurance companies. The Bank Act, however, proved insufficient to quell widespread anger over FNCB's Mercantile investment; in late 1970 Canadian officials and FNCB agreed that the Mercantile Bank would revert to a minimum of 75% Canadian ownership no later than 31 December 1980. As an act of good faith, FNCB then deposited 75% of its present shareholdings with a Canadian trustee.

The percentage of US stocks in the portfolios of Canadian mutual funds -- 45% in late 1967 -- became an issue in early 1968. The Canadian

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\* Furthermore, there are at present no branches of US banks located in Canada. US and Canadian commercial banks, however, do enter into international consortium arrangements -- for example, the Orion banking group, headquartered in London to service multinational concerns, includes Chase Manhattan, Royal Bank of Canada, Westdeutsche Landesbank Girozentrale, and National Westminster Bank.

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mutual fund industry, however, was able to thwart closer regulation on the grounds that, at the time, US stocks were excellent vehicles for appreciation and that, if Ottawa acted, Washington would react in like fashion. In mid-1969, Merrill Lynch purchased the Royal Securities Corporation (Montreal), one of several brokerage houses authorized to bid on Canadian Government securities.

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Although Canadian officials allowed the Merrill Lynch purchase, the incident prompted substantial parliamentary debate and the introduction of an amendment -- later defeated by the Conservatives -- to limit to 15% the firms on the Toronto Stock Exchange that were less than 75% Canadian owned.

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Table VII-1  
Canadian Security Issues

	Million US \$										
	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970 Jan-Jun
A. Shares	250	468	344	385	500	543	608	505	579	903	258
B. Bonds (public & private)											
Gross placements	4,258	4,998	4,818	4,949	5,220	5,184	6,198	6,310	8,370	8,019	2,768
Of which:											
Foreign placements	354	376	577	791	853	1,064	1,239	1,362	1,725	1,348	463
Net placements	1,423	1,789	960	1,539	1,434	1,194	1,580	2,043	1,880	622	856

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Table VII-2  
Canadian Foreign Bond Issues <sup>a/</sup>

	Million US \$											
	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970 Jan-Jun	Total
<b>Bonds with a Maturity of Five Years and Over</b>												
Public	193.3	34.5	0	25.0	0	150.0	347.5	672.5	780.0	847.5	367.0	3,417.3
Financed in												
United States	179.4	34.5	-	25.0	-	150.0	347.5	672.5	780.0	620.0	280.0	3,088.9
Germany	-	-	-	-	-	-	-	-	-	75.0	-	75.0
Switzerland	13.9	-	-	-	-	-	-	-	-	-	-	13.9
Eurocurrencies	-	-	-	-	-	-	-	-	-	152.5	87.0	239.5
Dollar	-	-	-	-	-	-	-	-	-	-	30.0	105.0
German Marks	-	-	-	-	-	-	-	-	-	107.5	-	107.5
Unit of Account	-	-	-	-	-	-	-	-	-	15.0	12.0	27.0
Private	158.3	332.6	572.5	756.7	818.5	893.8	824.9	683.4	855.0	500.8	96.3	6,492.8
Financed in												
United States	158.3	332.6	558.9	756.7	818.5	893.8	824.9	667.4	473.9	393.5	96.3	5,984.8
Germany	-	-	-	-	-	-	-	-	192.5	61.0	-	253.5
United Kingdom	-	-	3.6	-	-	-	-	-	-	-	-	3.6
Eurocurrencies	-	-	-	-	-	-	-	16.0	188.6	46.3	-	250.9
Dollars	-	-	-	-	-	-	-	-	-	-	31.3	-
German Marks	-	-	-	-	-	-	-	16.0	188.6	15.0	-	219.6
Percentage financed in the United States	-	-	-	-	-	-	-	-	-	31.3	-	31.3
Public	92.8	100.0	-	100.0	-	100.0	100.0	100.0	100.0	73.2	76.3	90.4
Private	100.0	100.0	99.4	100.0	100.0	100.0	100.0	97.7	55.4	78.6	100.0	92.2
<b>Bonds with a Maturity Under Five Years</b>												
Private	2.5	8.7	4.5	9.0	34.3	19.7	66.9	6.0	90.1	N.A.	N.A.	241.7
Financed in												
United States	2.5	8.7	4.5	9.0	34.3	19.7	66.9	6.0	5.2	-	-	156.8
Germany	-	-	-	-	-	-	-	-	76.5	-	-	76.5
Switzerland	-	-	-	-	-	-	-	-	8.4	-	-	8.4

a. Source: OECD Financial Statistics, 1970.

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## APPENDIX VIII

### Canada's Floating Dollar

#### Introduction

On 31 May 1970, Ottawa announced that its dollar, pegged at US \$0.925 since 1962, would be allowed to float freely in world currency markets. Although the government indicated that it would resume its obligation under the Articles of Agreement of the International Monetary Fund to establish a new parity for the Canadian dollar as soon as circumstances permitted, the float has continued for more than a year. There are no clear indications that Canada's dollar will soon be repegged.

#### Discussion

As Canada entered the 1970s, there was little optimism that the favorable economic performance of the previous year would be repeated. In 1969, real growth in GNP was 5.1%, unemployment fell slightly to 4.7% of the labor force, the balance of payments was in surplus by \$60 million, and Canada's international reserves increased to over \$3.1 billion. The dark cloud casting a shadow over this otherwise bright picture was a 4.5% advance in consumer prices.

To combat rapidly rising prices, Ottawa adopted a program of monetary and fiscal restraint. The bank rate, raised to 8% in July 1969, led a general increase in interest rates that pushed Treasury bill yields to almost 8% and provincial, municipal, and industrial bond yields to over 9% by the end of 1969 (see Figure 21). It was expected that this deflationary stance would depress both output and employment in 1970, but this was viewed as unavoidable if the inflationary spiral was to be broken.

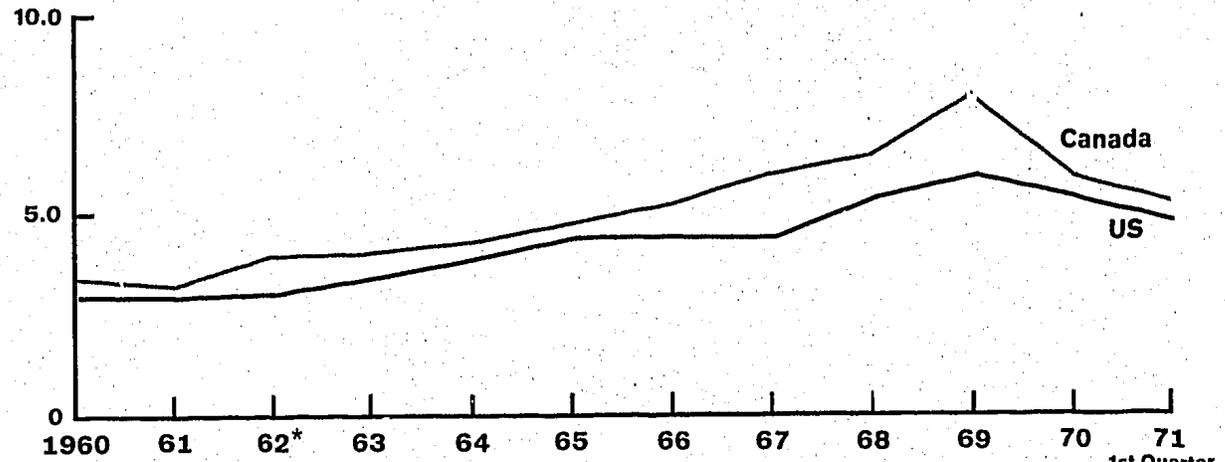
Inflation is especially serious because the country is largely dependent on exports for its prosperity. Thus the government felt that it had to dampen inflationary pressures if Canada were to maintain its international competitiveness,

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### CANADA and US: Interest Rates (at Year-end)

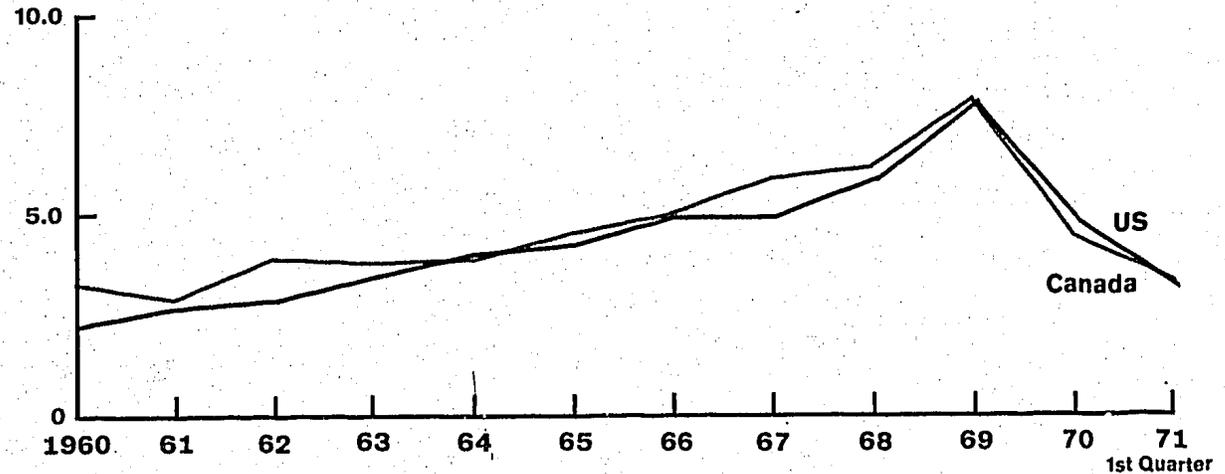
Figure 21

Percent  
Discount Rate

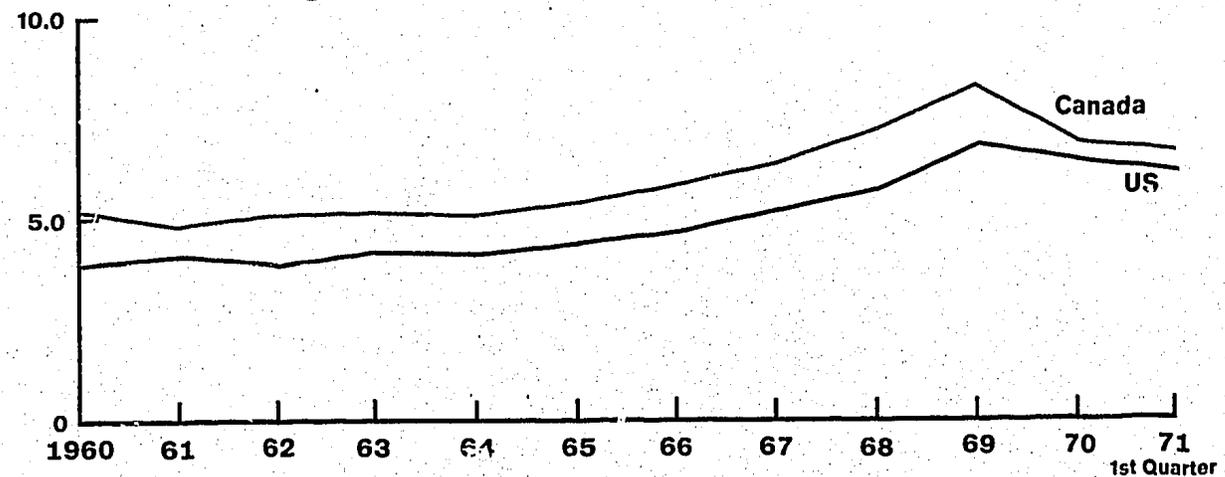


\*The Canadian discount rate was set at 6% in mid-1962 following the repegging of the dollar. It was subsequently lowered three times in the last quarter of 1962.

### 3 Month Treasury Bill



### Government Long-Term Securities



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and improve the long-term employment outlook via increased sales of manufactured goods abroad.

What Ottawa did not expect however, was a trade surplus approaching \$600 million in the first quarter of 1970. This was enough to produce a highly unusual surplus on the current account. In addition, the usual short-term capital outflows reversed in the second quarter of 1970 and large amounts of interest-sensitive funds, mainly from the United States, entered Canada -- attracted primarily by the high level of interest rates.

To an increasing degree in recent years, the ability to maintain the pegged rate has hinged on a large outflow of short-term capital. Long-term capital inflows greatly outweighed the traditional -- but steadily narrowing -- deficit on the current account, and short-term capital outflows prevented an unwanted buildup in international reserves, absolving the government of the necessity of buying US dollars with Canadian dollars to remain within 0.75% of the fixed rate of exchange. Thus the inflow of short-term funds, coupled with the massive trade surplus, created immediate problems for the government (see the tabulation below).

<u>Million US \$</u>				
<u>Year</u>	<u>Current Account</u>	<u>Long-Term Capital Account</u>	<u>Short-Term Capital Account</u> <sup>a/</sup>	<u>Overall Balance</u>
1965	-904.2	799.2	391.3	286.3
1966	-780.1	1,079.4	-336.7	-37.4
1967	-226.1	1,253.4	-773.3	254.0
1968	172.1	1,530.0	-1,108.2	593.9
1969	-301.4	2,087.7	-1,332.9	453.4
1970				
1st qtr	50.9	595.7	-282.1	364.5
2nd qtr	237.4	-41.4	539.8	735.8

*a. Includes errors and omissions.*

The combination of the trade surplus, long-term capital inflows, and the turnabout of short-term capital in the second quarter prompted a

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massive increase in Canada's international reserves in early 1970. At the end of April these reserves were \$3.8 billion, up from \$3.1 billion at the end of 1969. In April alone, \$225 million was taken in by the Bank of Canada. Furthermore, the inflow of dollars did not ease in May, even though the Central Bank cut the bank rate from 8% to 7.5%. By comparison, the US discount rate was 6% during this period.

To keep its dollar below the official ceiling of US \$0.9324, Ottawa was forced to buy US dollars with Canadian dollars, thereby prompting a fall in the government's cash balance from \$1.3 billion at the end of 1969 to less than \$290 million in late May 1970, despite a \$230 million Treasury bill issue earlier in May to replenish government cash holdings. With the publication of the May reserve figures imminent, along with the information that reserves would have increased by an additional \$360 million in May had not the Central Bank arranged for forward delivery of these funds, the government believed it was on the verge of an exchange crisis.

Fearing that the May reserve information would promote an unmanageable speculative inflow of foreign exchange, the government announced on 31 May 1970 that its dollar would henceforth float freely on world currency markets. Thus, Canada once again abandoned fixed exchange rates in favor of a floating dollar.

Previous Experience with a Floating Dollar

The last time Canada had floated its currency was in the fall of 1950. The decision to float then followed two unsuccessful attempts to find an appropriate fixed parity for the dollar. In the third quarter of that year, foreign exchange flooded into Canada and forced the government to abandon its defense of parity. After the rate was freed, the dollar appreciated rapidly until it reached US \$1.04 in 1952. From that time until 1960 it fluctuated between US \$1.00 and US \$1.06 without any obvious trend. Day-to-day and week-to-week movements in the rate were almost universally small, and the fears that the floating

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rate would depress Canada's international trade and foreign investment in Canada proved largely unfounded.

The floating rate of 1950 came to a somewhat unassuming end in 1962 when the government's "open mouthed" attempt to reflate the economy by "talking" the exchange rate down caused speculators to move out of Canadian dollars en masse -- thus precipitating an exchange crisis that culminated in the pegging of the dollar at US \$0.925 in 1962. On the whole, however, Canada's experience with the float was quite satisfactory -- particularly from 1950 to 1960. In addition, Canada had floated its dollar in the 1930s. Then, as in the 1950s, the exchange rate behaved well. Thus, the lessons Canada learned from previous floats probably gave the government confidence that the float of 1970 could help reduce the large inflows of foreign exchange without causing destabilizing effects in Canada if appropriate monetary and fiscal policies were followed.

Options Facing the Canadians

What were the options facing the Canadians in May 1970 to deal with a threatened, mounting inflow of speculative funds? Doing nothing was not a realistic alternative, as the increasing inflows of foreign exchange were hindering the government's anti-inflationary stand. Moreover, further government borrowing in the already tight Canadian money markets would send other borrowers to New York and so increase both the inflow of foreign capital and the domestic money supply.

Perhaps the most realistic alternative would have been to revalue the Canadian dollar upward. There were several reasons why the Trudeau cabinet did not believe this was a satisfactory course of action. The unsettled state of the US economy was relevant in that it was hard to predict future pressures on the US dollar.

Thus, it was unusually difficult to determine the proper amount by which the Canadian dollar should be revalued. If the dollar were revalued too much, and the expected economic recovery in Canada stimulated import demand, the current account

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balance could easily weaken. Then, Canada would be left in a situation where its exports were not as competitive as they had been prior to revaluation. Or, if the revalued peg was set too low, the possibility would exist that speculators would try to drive the Canadian dollar off its new peg.

Variations of fixed rate systems conceivably could have been adopted by Canada, like wider bands around the peg or a crawling peg system. Canada's earlier experience with floating rates supplied the government with sufficient background to opt for this solution, although it was no more acceptable than the other variations under IMF rules.

Although a year has passed since the float began, it is still too early to evaluate fully the results. Several preliminary observations can be made, however. After the fixed rate was abandoned, the dollar appreciated steadily, and by year-end the Canadian dollar was nearing parity with the US dollar. Foreign exchange reserves rose rapidly during the summer of 1970 as the Bank of Canada purchased US dollars to ease the upward pressure on the exchange rate and forward contracts matured, but further purchases of US dollars in the fall and winter were small. For the most part, it would appear that while the Bank of Canada has intervened in the market to facilitate smooth movement of the exchange rate, it has not attempted to influence greatly the level of the rate.

Since the float, interest rates in Canada have been allowed to ease as Ottawa alleviated inflationary pressures through fiscal and exchange measures; the bank rate now is 5.25% and Treasury bill yields have fallen to just over 3%. This currently has a two-pronged effect. First, it helps Canada's drive to reduce unemployment, which was 6.7% in April 1971, and second, it helps relieve upward pressure on the exchange rate as short-term capital is no longer attracted by high interest rates.

The most obvious effect of the appreciation in the exchange rate is cheaper imports for Canadians, while Canada's exports are relatively more expensive abroad. Cheaper imports were a

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decided advantage in the fight to halt inflation as importers, if not willing to reduce prices to consumers, were at least willing to hold the line on price increases. The rate of inflation in 1970 dropped to 3.3%. The increase in prices to foreigners of Canadian goods seems to have had little effect on Canada's export sales. Demand for many of Canada's exports is probably inelastic; small increases in price have little effect on sales. Nevertheless, some Canadian firms, particularly in the forest product and auto parts industries, claim to be hard hit by the Canadian dollar's appreciation. Many resource industries' export prices are quoted in US dollars, some firms have had to maintain US dollar prices at the cost of reduced profits in terms of Canadian dollars, or else raise foreign prices and risk loss of sales. Also, these industries claim that some investment projects have been postponed because of the uncertain future of the exchange rate. Nevertheless, it should be noted that these competitive problems have arisen from the appreciation of the exchange rate rather than from a flexible rate per se. The same problems would have arisen had Canada opted for revaluation to the US \$0.98-\$1.00 range. The fact remains that Canada could not maintain the fixed exchange rate at US \$0.925 except through the inflation that a large balance-of-payments surplus and the resulting speculative inflows would cause. What Canada has gained is a greater degree of freedom in setting its domestic monetary and fiscal policy without feeling the direct constraints of balance-of-payments considerations.

Canada's floating dollar has not been harmful to the United States. A higher exchange value of the Canadian dollar acts as a stimulant for US exports, while at the same time it has a tendency to reduce US imports from Canada. This has a favorable impact on the US balance of payments. Because the exchange rate of the Canadian dollar has not been subject to violent or large fluctuations, it has had little effect on Canada's international trade or investment position. Canada's imports from the United States failed to show strength in 1970, not because of the floating dollar but because of the generally depressed state of its economy. If anything, had the

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exchange rate remained fixed at US \$0.925, our exports to Canada would have probably been even lower because they would have been more expensive in terms of Canadian currency.

### Prospects

Although the exchange rate of Canada's dollar had been around US \$0.99 for the first five months of 1971, in late May and early June the rate began to fall. Uncertainty concerning the budget and tax reform pushed the rate to its lowest level in eight months in early June -- US \$0.9767. In addition, the prospect of US competition in grain sales to Communist countries, raised by the removal of the requirement that 50% of US grain exports had to be shipped in US bottoms, exerted further downward pressure on the exchange rate. This has prompted some traders to speculate that the dollar was nearing a point at which it could be repegged. We believe, however, that the government will want to test this lower rate before fixing the exchange rate. It could be 1972 before the rate can be evaluated in the light of a reflating economy.

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## APPENDIX XI

Methodology

The trade and balance-of-payments statistics employed in this memorandum differ somewhat from those in other US and Canadian publications. In particular, the following three adjustments have been made:

1. To estimate the US-Canadian trade balance, import statistics are used exclusively. We use Canadian import statistics as a measure of US exports to Canada while employing US import statistics as a measure of Canadian exports to the United States. Because import surveillance is generally more comprehensive than export surveillance -- particularly where the countries are in such close physical proximity -- the use of import statistics provides a more accurate estimate of the US-Canadian trade balance than does the use of either of the very different US or Canadian figures for the trade balance.

2. To estimate the real balance-of-payments costs (that is, foreign exchange costs) of US-Canadian trade, an adjustment has been made to reflect the differences between the market value of the reported imports of automotive products (that is, the value used in US import statistics, and in Canadian import statistics through 1969) and the lower transactions value upon which company payments are actually based. The adjustments made to reduce US imports statistics are:

<u>Million US \$</u>					
<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>
-12	-56	-125	-201	-279	-272

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and to reduce Canadian import statistics are:

Million US \$					
<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>
-10	-30	-60	-83	-81	0

3. All values are reported in US dollars. To convert Canadian dollar figures to US dollars, the following conversion rates of the US dollar per Canadian dollar are employed:

<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>
1.031	0.987	0.936	0.925	0.925	0.925
<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	
0.925	0.925	0.925	0.925	0.958	

The adjustments made in the US-Canadian trade balance have been carried forward with corresponding adjustments having been made in the US-Canadian current account, US-Canadian basic balance, Canadian worldwide trade, Canadian worldwide current account, and Canadian worldwide basic balance, and the US worldwide trade, current account, and basic balances.

The use of import statistics exclusively and of the automotive valuation adjustment is considered by most authorities to be the most effective way of getting a realistic picture of US-Canadian bilateral trade flows. The effect of the adjustment is to give an estimate very nearly half way between the US figure, after making an automotive valuation adjustment, and the Canadian figure. In 1970, the bilateral trade deficit as reported by the Bureau of the Census was approximately \$2,010 million (see Table XI-1). However, after making an automotive valuation adjustment the Department of Commerce's Office of Business Economics reported

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the deficit at \$1,645 million. Canadian statistics reported the deficit at \$1,037 million. Using the foregoing method the deficit is \$1,365 million.

Table XI-1

US-Canadian Bilateral Trade  
and Current Accounts

	Million US \$				
	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>
As reported by the Department of Commerce, Office of Business Economics					
Trade balance	494	84	-453	-815	-1,645
Current account balance	1,431	661	389	28	-625
As reported by the Canadian Bureau of Statistics					
Trade balance	896	573	-168	-343	-1,037
Current account balance	1,878	1,241	741	678	-32
As used in this memorandum					
Trade balance	524	392	-427	-648	-1,365
Current account balance	1,583	1,006	470	285	-311

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Figure 24

